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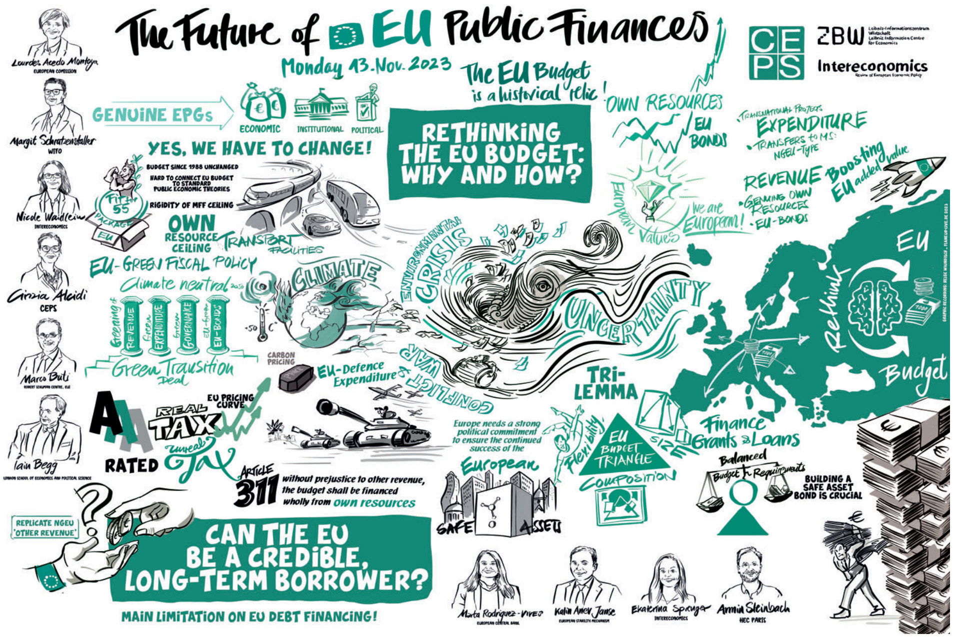
The Future of EU Public Finances

The European Union has weathered a number of turbulent storms in recent years from the COVID-19 pandemic to the ongoing war in Ukraine. These crises have highlighted the limitations of the EU budget and the need for the flexibility to adequately respond to challenges in real time. They have also raised questions about the legal feasibility of more common debt following a dramatic increase in EU borrowing. What are the obstacles – and the opportunities – for the EU's public finances in the face of the numerous crises of our time? Is it possible to balance predictability for long-term investments and flexibility to react to unexpected turns of events? This Forum addresses these questions and builds on the discussions at the 2023 joint Intereconomics/CEPS conference.



Rethinking the EU Financial Architecture

Lourdes Acedo Montoya, European Commission, Brussels, Belgium.

EU Finances in Search of a New Approach

Iain Begg, London School of Economics and Political Science, UK.

Elements of a European Green Fiscal Policy

Margit Schratzenstaller, Austrian Institute of Economic Research (WIFO), Vienna, Austria.

Towards a Common EU Debt: Where Do We Stand?

Marta Rodríguez-Vives, European Central Bank, Frankfurt, Germany.

Tax and Debt Financing the EU

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Developing European Safe Assets

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Rethinking the EU Financial Architecture

The multiannual financial framework (MFF) promotes and finances EU priorities across the member states and beyond the external borders of the EU. It provides for the financing of programmes and actions in all policy areas, from agriculture and regional policy, to research, enterprise and space, in line with the EU's long-term priorities.

The past, present and future of the long-term EU budget: Setting the scene

While faithful to its original endeavour to foster long-term investments, the EU must respond to the increasingly urgent calls to do something about cross-border needs and recurrent crises. The agreement on the MFF 2021-2027 together with the NextGenerationEU (NGEU) recovery instrument was a clear example thereof. The Union provided a timely and sizeable response to the COVID-19 pandemic and its economic fallout with a €2 trillion budget, the largest ever. It is also a transformative response with new and reinforced priorities accounting for 31% of the MFF (see Figure 1) and 50% when considering NGEU altogether.

The current MFF and NGEU brought further novelties. First, driving the climate and digital transformations is a common feature across the MFF and NGEU. Furthermore, with the Recovery and Resilience Facility (RRF), the EU finances reforms for the first time with a strong link to the European Semester and puts a stronger focus on performance-based spending. In another first on the financing side, the Union issues common debt with NGEU to finance spending programmes through the EU budget. This borrowing is guaranteed by a dedicated own resources ceiling fully enshrining the response to the crisis in the "community method" – contrary to past experiences in which intergovernmental solutions were sought.

Over the past three years, the EU has faced a series of unprecedented and unexpected challenges: Russia's brutal invasion of Ukraine and its fallout; surging inflation on the account, notably of high energy prices; an unprecedented rise in interest rates; the resurgence of migration after the pandemic; natural disasters in several member states; and most recently the Israeli-Palestinian conflict with devastating humanitarian consequences.

The EU has successfully reacted to the various challenges and has achieved a great deal. The EU budget has been instrumental in powering the Union's response. On top of built-in budget flexibilities, there has been extensive use of redeployments and reprogramming. For example, cohesion funds were mobilised to support people fleeing from war in Ukraine as well as the destination member states. REPowerEU, which aims to end the EU's dependence on Russian fossil fuels and tackle the climate crisis, is financed mostly through repurposing other funds. In only three years, nearly three-quarters of the budget margins have been used or planned. The availabilities of the special instruments and programme specific flexibilities, like the Neighbourhood, Development and International Cooperation Instrument (NDICI – Global Europe) are also being rapidly exhausted. Against the backdrop of a fundamentally changed context and rapidly decreasing available resources, the Commission proposed a revision of the MFF on 20 June 2023.

In fact, compared to national budgets, the EU budget is very rigid. Expenditure ceilings are set for seven years, whereas national fiscal frameworks often last around three or four years and work with adjustable ceilings (European Commission, 2023). Under the MFF, there is virtually no flexibility across the different headings. Expenditures in the EU budget are often set for the whole period being pre-allocated to member states or to specific programmes with limited flexibility to adjust. This results in a setup where it is very difficult to reprioritise and ultimately to react to new circumstances and priorities. Predictability of investments and member states' contributions to the budget currently carry more weight than flexibility.

Challenges ahead

Moreover, with the repayment of NGEU and further upcoming challenges, the future EU budget will face in-

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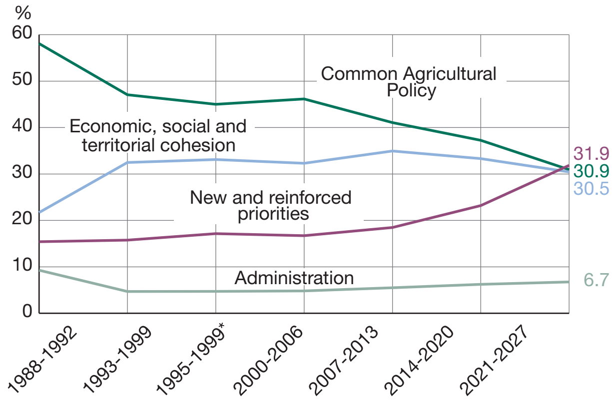
Figure 1

Share of the main policy areas in the multiannual financial frameworks without NextGenerationEU



Note: * MFF revised due to enlargement.

Source: European Commission (2021).

creased pressure. The world is changing and there are several challenges ahead that require deep and far-reaching transformations that should guide the framing of the next MFF to optimise the possibilities of the EU financial architecture (see Figure 2).

Global changes

First, global competition is strong, and if the EU wants to avoid falling behind, action is needed. It will be necessary to future-proof the EU's economic model and build comparative advantages, which will require a reassessment of our budgetary instruments to adjust, as necessary, to this new reality. For instance, this could be done by achieving climate neutrality and reaping the benefits of the digital transition, as well as pushing the technology frontier and reducing technological gaps between the EU and the United States and China (Steinberg and Wolff, 2023). Furthermore, creating secure supply chains, including the safeguarding of open strategic autonomy in key economic sectors, is highly important. Finally, investments in skills and re-skilling workers will be crucial to implement these economic transitions.

The world is changing, with important geoeconomic and geopolitical transformations on the way. An assertive Europe in this new world requires changes in the status quo of the EU budget both for external and internal instruments. External instruments should become even more strategic. With global conflicts and tensions on the rise, joint financing for defence and space will likely necessitate larger financial support from the budget. Furthermore, the EU should reduce its dependency on strategic goods, such as energy, and make supply chains more resilient overall. Additionally, migration has been an escalating challenge, both internally and externally. This is unlikely to disappear and could rather become an even more pressing issue in the future, which will require coordinated EU action. In general, the shifting geopolitical context requires the EU to clarify its role in the global system and develop a new vision for external and internal action. A common EU response will require financial resources that correspond to the challenges ahead. Furthermore, political discussions are ongoing about a potential EU enlargement. The timing and scope of such an enlargement are key variables that are impossible to foresee today. However, it is clear that a potential enlargement will bring additional challenges to the EU budget that need to be considered in the design of future policies, both for pre-accession financial support as well as for internal policies.

Cross-cutting transformations

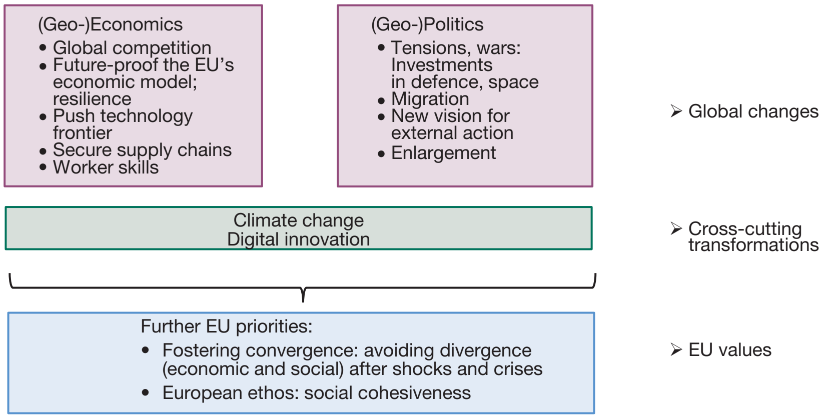
The second challenge is the transformation of economies in view of digital innovation and climate change. For instance, the European Chips Act will bolster the EU's competitiveness in semiconductor technologies and applications (European Commission, n. d.). Actions taken by the EU to achieve a climate-resilient economy cover both climate change mitigation and adaption (Council of the EU, 2021). Hence, efforts to promote the transitions of the economies are underway but the investment needs are very substantial and will span decades. The budgetary architecture of the future must be able to support these transformations through investments, while also providing flexibility in case of unforeseeable developments or crises.

EU values

Third, even with the vast and many challenges, it remains important to safeguard central EU values and not overlook non-economic public goods. This includes fostering economic and social convergence between the member states and regions. It should continue to be a core EU value to mitigate economic and social divergence after crisis shocks as well as to promote stronger resilience of the economies to prevent bigger slowdowns and divergence. Social cohesiveness across Europe and support for EU values – e.g. rule of law, education, justice – will remain essential to a strong Europe in a fragmented world.

Optimising the EU financial architecture and financial possibilities of the Union will be necessary in light of these important needs. This means, first and foremost, that new own resources for the EU budget are key. It also means considerations as to how to best combine EU and member states fiscal efforts, as well as how to best use the EU budget to crowd in private investments or whether the

Figure 2
The next multiannual financial framework in context: Issues to address



Source: Own illustration.

provision of loans guaranteed by the budget bring an additional value in specific cases.

Reflections on future EU financial architecture

Reflections on future EU financial architecture could be organised along four blocks: areas of expenditure at the EU level, expenditure instruments, financing instruments and governance structures. These blocks also provide the structure for the remainder of this article.

EU added value: Areas of expenditure

There is consensus that the EU budget should finance areas of strong EU added value, which some call European public goods. These are areas that are best financed at a supranational level for several reasons. First, public goods are characterised by non-excludability and/or non-rivalry. That is, actors not contributing to the good cannot be excluded from its benefits, or its use by one more actor only has a marginal and decreasing cost (Buti et al., 2023). For the EU, this would mean that individual member states might have too little incentive – or capacity – to provide enough of these goods. Second, European public goods are characterised by economies of scale and scope, meaning that pooling the production will reduce the price. They include a cross-border dimension, which implies a less effective provision of the good by individual countries. These goods are key to pursuing the EU's strategic priorities. Thus, providing the public goods at the EU level would be more efficient.

The creation of EU added value also comes from coordination and spill-over effects, due to the high degree of economic integration within the EU. For instance, quantitative analysis suggests that the effect of NGEU on EU aggregated GDP is one-third larger when explicitly accounting for spill-over effects across countries (Pfeiffer et al., 2021).

To maximise the positive effects of EU spending, both economic efficiency and shared political objectives should be considered. The latter may include asserting Europe's role in the world and ensuring its open strategic autonomy, the means to combat economic divergence and macroeconomic instability, and achieving key transformations towards a future-proof Europe. The green transition and energy, for instance, can only be tackled meaningfully and efficiently if coordinated at the EU level. At the same time, despite all the new priorities arising from the changed geoeconomic and geopolitical context and large transformations, EU core values of convergence and cohesion must not be forgotten. The EU budget can also foster political priorities; for instance, it helps to safeguard the rule of law in the EU. Furthermore, the RRF has shown that the EU budget can also finance and stimulate reforms that contribute to the green and digital transition and also support economic and social cohesion. Both reforms and investments will be key for a competitive, resilient and cohesive Europe in the future.

The EU budget also contributes to economic stabilisation. There is a role for the EU to intervene in the event of shocks, to counteract imbalances between member states and to help avoid sovereign debt crises. The SURE (Support to mitigate Unemployment Risks in an Emergency) instrument, which provides loans to member states, as well as the Recovery and Resilience Facility, are examples of an economic stabilisation function albeit of a temporary nature. On a smaller scale, cohesion policy or the European Globalisation Fund have also provided economic relief in the face of an economic shock. Going forward, it could be considered whether stabilisation brings EU added value and should be provided by the EU budget.

The EU budget can also create added value through the way it is financed. The new own resource based on non-recycled plastic packaging waste can serve as an example here. It is linked to the EU's policy objectives and can create an incentive for member states to improve recycling. NGEU also shows that the EU can borrow commonly to help counter financial imbalances and needs across member states. This suggests that revenue and expenditure should be considered jointly as both support political priorities, and coherence between them can create additional value.

Expenditure instruments

Not only the question of what the EU budget should finance is important, but also how it should be delivered. To reap the full benefits of the EU budget, the delivery method should be carefully crafted, and several factors should be considered. The policy objectives must come first, as they set the priority for what should be achieved. Then, the most efficient financing for achieving the stated objectives needs to be found. Paying close attention to the link between on *what* and *how* money is spent is crucial.

There are several potential delivery tools. They include guarantees, grants, or loans, as well as the choice between different management modes (direct, indirect, or shared management). The different modes of spending should correspond to distinct spending logics: either pre-allocated envelopes based on national plans that consider the specific context of the member states or non-pre-allocated programmes based on competition between member states, organisations and other stakeholders. The latter are in principle equally accessible to all. Each delivery mode can – and should – create EU added value. In defining a delivery mode, different combinations of the discussed elements may be optimal depending on the policy area or priority.

The role of performance-based spending could also be strengthened. It has the potential to increase the effectiveness of EU expenditure. The performance framework has already been upgraded in the MFF 2021-2027. However, there is still room for improvement. One option to explore could be to integrate performance considerations to a larger extent in the design of the annual budget as well as the next MFF. For this, an all-encompassing review of EU spending and its structure, including performance-based indicators, would be necessary. At the same time, it might be worth taking stock of and optimising the EU's different systems of tracking, monitoring and evaluation. The resulting insights may then be used to simplify the structure of the EU budget, for example, by reducing the number of programmes where it makes sense. This could also help reduce costs and increase efficiency, transparency and accountability.

Lastly, sound financial management could be further improved by enhancing coordination of the various control mechanisms. The MFF 2021-2027 already brought important changes to achieve sound financial management. The objective is to ensure effective budget protection at minimal cost.

Simplicity and efficiency should be the guiding principles of future financing instruments. This simplicity could take the form of a critical assessment of the number of instruments to reduce potential overlaps and exploit positive synergies. Simpler applications for beneficiaries and strong coordination between instruments that have similar policy objectives but that are implemented through different modes should also be further developed. Efficiency will ensure that funds can reach the ground as quickly as possible and that they are designed to deliver on their policy objectives and to ensure sound financial management.

Financing instruments

To leverage the full capacity of the EU budget, all possible sources of financing as well as their efficiency and fitness for purpose should be considered.

New own resources are key to balance the revenue structure of the budget in light of future expenditure needs. The Commission has proposed new own resources linked to the Emissions Trading System and Carbon Border Adjustment Mechanism as well as a new statistical own resource based on company profits. The earlier the agreement on these resources, the better. These proposed new own resources are closely aligned with our common policy objectives, and therefore have the potential to also bring EU added value through the revenue side of the budget.

While joint borrowing is not an objective on its own, it is an instrument that can contribute to the enhancement of the financial capacity of the Union and contribute to efficient delivery of spending instruments. Joint borrowing also brings side benefits insofar as it promotes the international role of the euro and deepens EU capital markets. It enables risk-sharing among member states and increases the financial capacity of the EU budget. For decades already, the Union has been borrowing to support member states and third countries with loans to address balance of payments crises. NGEU borrowing provides loans and grants for expenditure programmes in the EU budget, whether implemented by member states such as the RRF or the European Agriculture Fund for Rural Development or at the EU-level such as InvestEU or EU4Health. The EU budget headroom, which is the difference between the own resources ceiling and the expenditures of the EU budget, guarantees these liabilities, including with a dedicated own resources ceiling solely for the purposes of NGEU.

In the case of loans to third countries, the latest loans to Ukraine are covered by the headroom of the EU budget and in other cases a provisioning fund also provides first coverage via the budget. Finally, the SURE instrument provides loans to member states, which are partly guaranteed by member states and partly by the EU budget. While the repayment of loans is done by the beneficiary countries, the repayment of grants and in some cases an interest rate subsidy to Ukraine is done via the EU budget. All of those are examples of how borrowing can be an instrument to deliver on EU policies and needs which should be assessed in the next cycle with the same objectives of simplicity and efficiency.

External assigned revenue could continue to play a certain role. It has been highly important, with NGEU but also with the EU's Emissions Trading System financing the Social Climate Fund. External assigned revenue, however, deviates from the principles of universality and unity and should not be the norm. However, it could still play a role, ancillary to budget financing, for example, for member state's contributions to external action programmes or with third countries' contributions to Union programmes.

Crowding-in other sources of funding should also be further explored. Co-financing by member states or other beneficiaries can bring more complementarities between member states and EU-level expenditures and increase the available resources for European priorities. Private sector participation in programmes can also help deliver a higher share of investments with the backing of the EU budget.

Governance structures

The MFF includes many elements that are deeply interlinked. Beyond the policy priorities and delivery mechanisms, important elements are the governance structure and the duration of the MFF. On the one hand, a certain length is required to enable long-term investments, which are underpinned by multi-annual programmes. On the other hand, a longer duration means a less responsive budget to react to crises and new needs and raises questions of democratic legitimacy.

Finally, the MFF and its programmes could be brought closer to existing EU governance processes, as has already been done in a few cases. The RRF brings the EU budget and the European Semester very close, and this can set a positive precedent for the future to guide the most important economic reforms and investments in member states that contribute to shared goals like the provision of European public goods or strengthening the long-term growth potential. The Social Climate Fund will rely strongly on the governance of the Energy Union and the national energy and climate plans. Similarly, a closer interlinkage between external policy objectives and EU external action instruments could also be sought in the future. A close coordination between governance structures and EU budget instruments can leverage the Union's overall impact within and outside of its frontiers.

Concluding remarks

The EU budget is the financial arm of the Union's policy goals. In assessing the MFF and looking ahead, several conclusions can be drawn. First and foremost, the added value created through the EU budget should be maximised by taking an all-encompassing view of the budgetary architecture, including the revenue side and the coherence between financing and spending elements. Second, spending on the EU level benefits all member states, and not just those directly receiving funding. Hence, the EU budget should not be seen as a zero-sum game. Third, flexibility, simplicity and efficiency will be guiding principles in the design of the next generation of programmes. The structure of EU spending should also be reviewed, e.g. the number of programmes, and the connection between the budget and other governance processes. Fourth, the budget architecture should optimise all financial means through a closer interlinkage between member states and EU-level expenditures, crowding in private expenditures. Most importantly, the introduction of new own resources is essential to better balance the revenue structure of the budget.

In conclusion, significant and important work lies ahead to ensure an EU budget that is better, more efficient, more flexible and policy-oriented. An EU budget with a bigger impact will be the task for 2027.

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EU Finances in Search of a New Approach

It has been said before, too many times: the EU budget is overdue for reform. Despite many changes in detail, the shape and procedures of the budget in 2023 would be easily recognisable to those who negotiated and implemented its major reform in 1988. So too would be many of the points of contention about it, such as the large proportion of spending allocated to Cohesion Policy and direct payments to farmers, the lack of flexibility, the impasse over new own resources and the persistence of rebates accorded to some member states on their gross contributions to EU revenue.

What would not be recognisable to a time traveller from the late 1980s is the proliferation of off-budget mechanisms through which important EU policies are funded. They include the various means by which financial assistance to third countries is distributed, ad hoc responses to crises (such as the sovereign debt crisis, starting with Greece, then dealing with refugees in 2015) and, most recently, the large programmes associated with the NextGenerationEU (NGEU) package, launched in 2020 in response to the COVID-19 pandemic. Borrowing and lending was not, of itself, a new phenomenon, with the European Investment Bank (EIB), in particular, being long established as a source of funding for investment projects. As Laffan (1997, 217) pointed out, there was a sharp contrast between "the fierce battles about the size distribution and objectives of the community budget and the largely uncontested second arm of the EU's finances".

However, the resort to off-budget mechanisms has a number of consequences that call for a recasting of the governance of EU finances. The prospect of a further substantial enlargement of the EU adds urgency to the issue and was explicitly mentioned by Ursula von der Leyen in her 2023 State of the Union address. Reflecting on what would need to be done prior to the accession of Ukraine and other likely candidates, she singled out the budget:

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* Some elements of this piece build on Grund and Steinbach (2023).

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"We need to discuss the future of our budget – in terms of what it finances, how it finances it, and how it is financed" (von der Leyen, 2023).

The latter half of her statement is succinct, but it is worth elaborating on its meaning. "What it finances" invites a reappraisal not only of the different headings of spending that have dominated EU budgets for decades, but also asking whether a more wide-ranging review of the expenditure side is needed. There are several facets of "how it finances it" to consider. Among them are: the choice between grants and loans, the extent of conditionality, and whether (or when) co-financing by member states or other interests is justified. "How it is financed" could be somewhat narrowly understood to be the mix of EU revenue, currently dominated by net contributions, and the scope for boosting the share of "genuine" own resources. Having crossed the Rubicon of funding EU policies by direct borrowing from financial markets for NGEU, albeit temporarily, a separate aspect is whether borrowing should become a routine source of funds.

These three dimensions of the EU budget help to frame this article and are expanded in the sections that follow. However, there is another dimension to take into account. It stems from the broadening of EU finances, with the implication that they now need to be analysed as a whole, rather than being equated largely with the EU budget. Doing so requires attention to be paid not only to the different components of the galaxy of EU finances (Begg et al., 2022), but also to the complexities of the interactions between the different components. A key proposition of this article is that there is a need to develop an EU-level fiscal framework, distinct from those of member states.

What it finances: EU expenditure

The EU's expenditures derive from a combination of Treaty obligations, political choices made decades ago as well as more recently, pressures to support sectors and territories affected by economic integration, and some areas for which a case can be made that the EU is the most appropriate level of governance to undertake the spending. It is often described as a budget for investment, an assertion that can be defended for spending on Cohesion Policy and research, but is more questionable for direct payments (most of which go to farmers and still account for over a quarter of EU expenditure) and for a proportion of external action.

If, however, EU budget specialists were asked today to start with a blank sheet of paper and write down what the EU should spend on, it is a safe bet that it would be very different from the current list. But rather than focus on specific spending lines, the upstream question that needs to be answered is why the EU spends and what spending should be assigned to it in a multi-level system of public expenditure. Fuest and Pisani-Ferry (2019) list eight broad areas for European public goods (EPGs) and argue persuasively for putting the provision of public goods at the heart of European integration. They assert that "enhanced provision of European public goods requires additional funding, but it should not increase the overall tax burden for EU citizens"; their reasoning is that "the overall tax burden should decline if public goods are more efficiently provided at European than at national level" (Fuest and Pisani-Ferry, 2019, 2).

A useful approach to EPG is provided by Buti et al. (2023) who distinguish between: provision by the EU level in the pursuit of EU policy goals; transfers to member states, nevertheless aimed at EU objectives; and inter-governmental transfers to member states to fund national public goods. Buti et al. argue that the first category is the easiest to justify and, as a corollary, least prone to the disputes about net contributions and *juste retour* that have been so toxic over the decades. It potentially encompasses a variety of public spending, including responses to climate change, much of EU external action (although there can be overlap with national policies) and administrative activities required to sustain the Union.

The second category is exemplified by how the funding from NGEU is distributed, with the obligation to devote much of the funding to climate actions and digitalisation – the twin transitions at the heart of current EU policy narratives. However, there are sizeable net fiscal transfers from the Recovery and Resilience Facility (RRF), which, though temporary, enable net recipients to boost public investment without aggravating fiscal policy stresses, thereby fulfilling a macroeconomic stabilisation function. EU funding of national public goods is both allocative – investments intended to promote economic growth – and distributive, albeit between member states, rather than in the sense conventionally used in public economics (dating from the seminal work of Musgrave, 1959) of between richer and poorer households or citizens. The investment supported by, above all, cohesion policy encompasses infrastructure and other goals such as enhancing skills, social inclusion or territorial balance.

Discussion of what constitutes EU added value (EVA) is closely related to EPGs, but finding agreement on it is difficult. In some respects, EVA is an intuitively obvious concept, yet also a devilishly slippery one. A comprehensive special issue of the European Court of Auditors Journal (2020) illustrates its complexity and offers a plethora of interpretations. Often, discussion of EVA slides into justification of EU integration overall, with many contributors to the special issue emphasising the broad regulatory role of the EU. However, in considering the EU finances, it can help to narrow the debate to simpler aspects of EVA. While economic efficiency – whether through economies of scale and scope, or elimination of damaging externalities, such as adverse spillovers – is a powerful rationale, it cannot be the sole justification for EU-level spending. A related rationale is to ensure that a suitable quantity of public goods is produced, a goal that may be compromised at other levels of government if they are unable to appropriate the benefits of its spending and, consequently under-invest. In addition, as Rubio (2020) stresses, there are political considerations which sometimes over-ride economic principles.

How it finances it: Mechanisms for, and governance of, spending

EU funding can be split along a number of dimensions. Grants from Brussels were traditionally the mainstay of EU budget funding, but loans (known as financial instruments) have been used to a limited extent in cohesion policy. More recently, as noted above, loans have acquired greater prominence, especially in pandemic-related actions.

Borrowing by the EU to enable EU policies to be funded operates in different ways. The EIB has its own legal personality and funding arrangements and funds projects largely on a commercial basis, entailing investment appraisal intended to verify the validity of the project. Other EU borrowing is to fund loans for a specific purpose, ranging from Macro-Financial Assistance (Ukraine is a significant beneficiary today) to the temporary SURE instrument (agreed in 2020 and taken up by most member states) which sought to underpin national initiatives to maintain employment during the pandemic. These are back-to-back loans, which means the EU borrows (exploiting its favourable credit rating) then lends on to recipients who benefit from better loan terms than if they sought to borrow directly from financial markets. Recipients are responsible for repaying and servicing the loans, with the EU guaranteeing the loans.

NGEU was a new departure. Its loan component also operates through back-to-back loans, but the grant component means that future EU budgets become liable for debt service and repayment, the latter probably only starting from 2028 and extending for up to three decades. This has ramifications. First, the debt-related outlays will be a first call on the EU budget, outside the control of the Budgetary Authority (the Council and the European Parliament) in the sense that it cannot choose to alter the amount.

This, in turn, prompts questions about how these new payments are accommodated: essentially a choice between cutting other expenditure or raising additional revenue, although a possibility would be more extensive co-financing, either at the national level or other stakeholders. In this context, there has long been pressure from net contributors to keep the headline total of the EU budget low as a means of capping what they have to contribute. Unsurprisingly, net recipients, the Commission and the European Parliament take the opposite view. The principal alternative is to raise additional revenue, either through higher national contributions or through new own resources; neither is easy.

Conditionality has been a vexed question. On one side, pressures have grown over the years to ensure programmes are well-conceived – *ex ante* conditionality – with the goal of making it more likely that money will be well spent; this is not especially contested. Macroeconomic conditionality – requiring member states to adhere to sound fiscal policy – has been much more controversial, partly because it can be seen as punishing regions for the failings of national governments, but partly also because it can undermine economic development. Rule of law conditionality, as applied to funds from the Recovery and Resilience Facility (the main mechanism of NGEU), elicits the most rancour, because it imposes a political test on disbursement of funds, not just an economic one.

Related to conditions is evolution in the approach to monitoring and evaluation. The direction of change is towards performance-based budgeting (PBB), defined by the OECD (2023) "as the systematic use of performance information to inform budget decisions, either as a direct input to budget allocation decisions or as contextual information to inform budget planning". It entails a focus on what the policy produces by way of direct outputs and broader results, a contrast with the more conventional input approach under which recipients had only to show funds were being used in accordance with sound financing rules. The RRF, with its use of milestones and targets as the basis for disbursements, adopts a PBB approach, although work by Darvas et al. (2023) suggests it falls short of its stated ambitions. An open question in this regard is how useful common indicators can be in assessing programme success.

How it is financed: EU revenue

Proposals for new own resources to cover the NGEU repayments are set out in a roadmap in Annex 2 of the 2020 Interinstitutional Agreement,[1] and in the 2021 Own Resources Decision[2] which also included the introduction of a plastics levy as a new resource. The European Commission (2021) put forward a range of proposals, but conceded 18 months later (European Commission, 2023) that "the legislative discussions on the proposal made in December 2021 have made limited progress".

There are many obstacles to the introduction of "genuine" own resources, as distinct from national contributions (even though these are formally designated as own resources, meaning the member states are committed to honouring them), so much so that no new resources were approved between 1988 and 2021. Fundamentally, the problem is that member states are loath to accord a "power to tax" – a key feature of most polities – to the EU. The need for unanimity is also a deterrent to selecting new resources.

While there has been no shortage of studies and ideas on possible new resources (High Level Group on Own Resources, 2016; Schratzenstaller et al., 2022), a persistent difficulty is their uneven incidence on particular member states. Candidates proposed over the years include carbon taxes to be collected by the EU, a share of corporate income tax, financial transactions taxes, obscure sources such as the monetary income of central banks, and even a small charge on every SMS text message sent. It does not take much imagination to see why member states using low corporate taxes as an instrument of industrial policy to attract inward investment would oppose an EU corporate tax, or why those with comparatively high proportions of fossil fuels in their energy mix would object to EU carbon taxes.

From the perspective of most member states, the largest share of own resource – the GNI contribution – has notable attractions. The formula behind it may be impenetrable to citizens, but for national finance ministries, it is a distinct line in their budgets and elicits only limited contestation once the septennial deal on the multiannual financial framework (MFF) and the own resources decision is concluded. For the EU level, the GNI resource has one key attribute which is to rise or fall as expenditure occurs, thereby balancing the budget while also assur-

1 Official Journal of the European Union, L 433 of 16 December 2020, 28-46.

2 Official Journal of the European Union, L 424 of 15 December 2020, Council Decision (EU, Euratom) 2020/2053.

ing the EU level of certain revenue. Many possible own resources would lack such certainty. Over the years, the GNI resource has also been one of the means by which member states that claim to face unfair net contributions have had them abated.

These "corrections" can seem perverse, especially when they routinely result in the gross contributions of richer member states as a proportion of GNI being lower than their poorer partners, but they have proved vital to overall agreement since first being conceded to the UK in 1984. They are nevertheless a decidedly peculiar way of managing the revenue side of the budget and there was a hope in 2020 that Brexit would allow a phasing-out of corrections. That it did not happen highlighted the deeply political nature of the EU budget. Although the plastics levy, introduced in 2021, is an innovation, it is tied to gross national income and is, consequently, de facto also a national contribution, leading some member states to argue that it adds to administrative costs for negligible benefits. Moreover, even this limited innovation is subject to a form of correction favouring member states with GNI per capita below the EU average.

An EU fiscal framework

The combination of conventional EU budget programmes and off budget mechanisms has come about more as a result of exceptional circumstances than explicit design. As the European Court of Auditors (2023, paragraph 93) explains, although "there were reasons for creating new types of instruments, the piecemeal approach taken to set up the EU's financial landscape has resulted in a patchwork construction of instruments with different sources of finance and governance arrangements".

Interactions between income and expenditure on one hand, and public debt on the other, are central to public finances in most polities and, it is worth recalling, are the subject of intrusive oversight at the EU level. It is, therefore, something of an irony that the implications of having EU debt have been insufficiently analysed. Begg et al. (2023) propose five dimensions for a putative EU fiscal framework: the first two are the traditional income and expenditure; then there is management of risks; and governance of decision-making and legitimation complete the framework.

The various linkages between the five dimensions are crucial for an EU fiscal framework (see Figure 2 of Begg et al., 2023). Increased debt service costs (or risks of default), for example, affect choices on income or expenditure. Risks generated by choices made by the Council and Commission, with the Parliament only consulted, can leave the Budgetary Authority to deal with the consequences. Much depends on how guarantees and provisioning are structured.

In the EU setting, the own resources ceiling plays a vital role because it does two things. First, the headroom between the MFF ceilings for expenditure and the own resources ceiling provides an assurance that member states will increase their contributions if called, for example, to cover defaults on loans. As a result, financial markets can regard lending to the EU as safe. Second, as occurred with NGEU, raising the own resources ceiling can boost the EU's capacity to borrow. Guarantees are also offered by a Common Provisioning Fund, established under Article 212 of the Financial Regulation, inside the EU budget, as a first line of support for certain loans.

Conclusions

The status quo bias afflicting the budget should be no surprise because it is the result of difficult compromises between competing sectoral interests, as well as those of member states with widely differing priorities and expectations of what the EU should fund. Equally, it is hard to deny that there are unrealistic expectations of what EU budgetary interventions should do, especially in alleviating crises, given the constraints on budgetary autonomy at the EU level, i.e. a capability-expectations gap. Insights from public economics may be useful, even if due allowance is made for the *sui generis* nature of the EU and its budgetary distinctiveness. For example, some of the propositions found in fiscal federalism, such as the principle of equivalence, might be adduced. This principle suggests that expenditure should be undertaken and financed in the territory where its benefits accrue, both to reflect preferences and to align incentives. It might reasonably be applied in support of funding demonstrably European public goods by genuine own resources.

The pathologies of the EU budget, and its finances more generally, are well known and point the way to a reform agenda. Considering recent demands for budgetary responses, enhancing the agility and flexibility of the EU level is a high priority, though the rigidity of the MFF model is an obstacle. An approach best characterised as incremental to altering the budget entrenches the status quo, and key governance mechanisms, not least the need for unanimity, make more radical change difficult. Yet the prospect of enlargement, as signalled in the quotation above from von der Leyen (2023), provides opportunities to rethink what purposes the budget serves. Answers should be rooted in a fresh look at the EPGs that the budget is best equipped to provide and improved understanding of how value is added by spending at the EU level.

The EU needs, in parallel, to decide how best to use borrowing and lending as an integral part of its budgetary strategy. Grund and Steinbach (2023) show convincingly that there is scope to do so without Treaty change. The piecemeal approach undoubtedly helped find solutions to, for example, the migrant crisis (the Facility for Refugees in Turkey) or the rapid implementation of SURE, but the EU should not rely repeatedly on cobbling together a package. A more comprehensive and considered framework would also enhance the “agility” of the EU budget by adding to options for actions.

Although the EU has repeatedly shown it can act quickly when pushed, the frequent use of Article 122 as the legal base for emergency action not only stretches the intent of the article, but also gives a disproportionate role to the Council in decision-making. The corollary is that the European Parliament is side-lined, undermining legitimation. A better approach would be to work towards an EU fiscal framework in which the interactions between the income and expenditure accounts and the balance sheet of EU finances are more coherent in how interventions are devised. Doing so would ease the sorts of complications that have arisen, such as the difficulties associated with servicing and repaying debt incurred to fund NGEU grants.

Regarding how to proceed, a first opportunity is the mid-term review of the MFF, currently in progress. It is unlikely to shift the dial massively, but could begin to alter the terms of debate on future EU finances. Proposals on the next MFF, likely to be put forward in the course of 2025, are a second opportunity, and also one with scope for greater innovation, because they will have to emerge early in the mandates of the next Commission and European Parliament.

What is it to be, yet another rerun of “groundhog day” or acceptance that the “time for a change” is now?

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Elements of a European Green Fiscal Policy

The European Green Deal, the core project of the current European Commission, envisages a green transition in the EU, which aims at making the 27 EU member states climate-neutral by 2050 and at reducing greenhouse gas emissions by at least 55% by 2030 compared to 1990 levels in a first step. Since it began in February 2022, Russia's war of aggression against Ukraine has been intensifying the urgency of the green transition, which would make Europe independent of fossil fuels imported from third countries and secure an affordable energy supply. Such an ambitious green transition requires a comprehensive "green fiscal policy" as one element of a broad mix of measures at the EU level to complement and reinforce member states' initiatives to green national public finances. A European green fiscal policy rests on four pillars, which are partly elements of the Fit for 55 package[1] aiming at achieving the goals of the European Green Deal (see Figure 1): the greening of revenues, the greening of EU expenditure, the greening of EU governance and European green bonds. Green implementation mechanisms can initiate and facilitate greening initiatives in a systematic way in the four green fiscal policy pillars.

Four pillars of greening EU fiscal policy

Greening of revenues at EU level

The first pillar of a European green fiscal policy is the greening of revenues at the EU level, which comprises two interrelated elements: carbon pricing and green own resources to finance the EU budget. Carbon pricing at the EU level includes the EU Emissions Trading System (EU ETS), the EU Carbon Border Adjustment Mechanism (CBAM), the EU Energy Tax Directive (EU ETD) and potential green EU levies. As part of the Fit for 55 package, the current EU ETS 1 covering industry and energy generation will be supplemented by a new EU ETS 2 for the building and the transport sector as of 2027. The EU CBAM was introduced in October 2023 starting with a transition phase and will be effective as a carbon pricing instrument as of 2026. The revision of the EU ETD, another measure of the Fit for 55 package, is still pending.

The coordinated implementation of further green levies in EU member states has not found its way onto the European agenda yet.

Currently, the lion's share of EU revenues are national contributions from member states (see Figure 2). In 2022, the VAT-based own resource contributed 8% of overall revenue including other revenue (€19.7 billion), the GNI-based own resource 42.4% (€103.9 billion) and the plastic own resource 2.6% (€6.3 billion). The share of custom duties, which since the end of the sugar quota system are the only remaining traditional own resource, amounts to 10.5% (€25.9 billion). The remaining revenues stem from other revenue and the balance carried over from the previous year.[2]

It is obvious that the EU system of own resources in its current form contributes in a very limited extent only to central EU objectives and policies (Schratzenstaller et al., 2017, 2022). Recently, the need to repay NextGenerationEU (NGEU) debt, newly emerging potential genuine own resources and mounting long-term challenges for the EU (e.g. climate, digital and demographic change) have provided new impulses to the long-standing debate about a fundamental reform of the EU revenue system.

Green own resources appear as particularly relevant in this context, as they would strengthen the link between EU revenues and EU spending and thus coherence between EU budget policies addressing climate change. The EU ETS, the EU CBAM and green EU levies offer themselves as green own resources.

The Interinstitutional Agreement accompanying the agreement of 2020 on the multiannual financial framework (MFF) and NGEU (which together form the European COVID-19 Recovery Plan) includes a roadmap for the stepwise introduction of new own resources as of 2021,

1 See Tagliapietra (2021) for an overview of the 13 elements of the Fit for 55 package.

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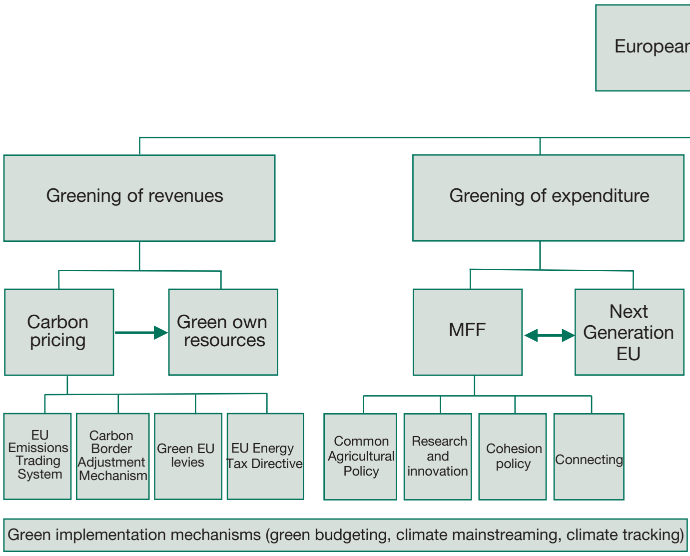
2 The volume of other revenue has been increasing markedly since 2021, as grants and loans provided to member states through NGEU are financed through EU debt, which also constitutes other revenue of the EU; however, this effect is only temporary.

Figure 1
The green transition: Pillars of a green fiscal policy in the EU



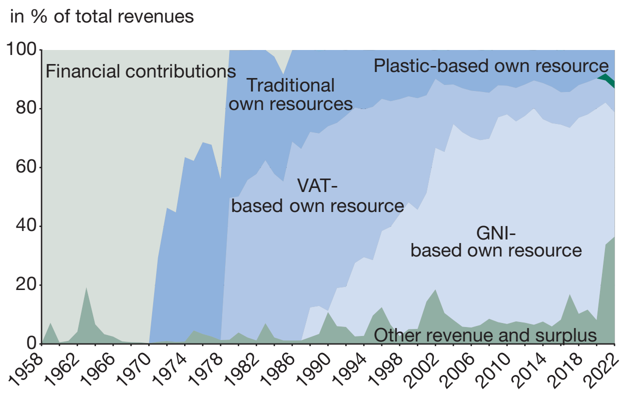
Source: Enhanced version from Schratzenstaller (2022).

which, inter alia, comprise green own resources. As a first step, a contribution based on the non-recycled plastic packaging waste was introduced as a new own resource in January 2021. At 2.6%, its contribution to EU revenues is rather modest, and it is expected to fall over the medium run, with non-recycled plastic waste decreasing. Moreover, the Commission put forward a proposal for a first basket of new own resources, comprising, inter alia, new own resources based on revenues from the EU ETS and the EU CBAM with a view to their introduction in 2023 (Schratzenstaller et al., 2022), which, however, has not been agreed on. As part of the MFF midterm review, the Commission released an adjusted first basket of new own resources in June 2023 to be introduced in 2024 (European Commission, 2023a).

This adjusted first basket includes an ETS-based own resource: 30% of all revenues from ETS 1 and ETS 2 shall be dedicated as EU revenues, with expected revenues for the EU of annually €7 billion as of 2024 and €19 billion as of 2028. In addition, a CBAM-based own resource is proposed: 75% of the revenues from the EU CBAM applying a carbon price from imports from third countries not applying carbon pricing to cement, steel and iron, aluminium, fertiliser, and electricity, with expected revenues for the EU of €1.5 billion per year as of 2028.

The revenues from the EU ETS and CBAM are particularly suitable as own resources to finance EU expenditure (Fuest and Pisani-Ferry, 2020): they stem from Union policies and can thus be considered genuine own resources of the EU. Moreover, they would not exist without EU-wide coordination, and emissions as the base of these revenues cannot be attributed properly to particular member states because of their cross-border nature. Moreover, they could be introduced without treaty changes (Schratzenstaller et al., 2022), and they

Figure 2
Composition of EU revenues in a long-term perspective, 1958 to 2022, including other revenue[1]



Note: [1] Other revenue includes taxes on the salaries of EU staff, contributions from non-EU countries to certain EU programmes, remaining UK contributions, fines and EU borrowings.

Source: European Commission (2023b), own representation.

would shift the burden from financing the EU budget from the general population to polluters. They should be introduced as soon as possible and complemented by additional green own resources options based on further green levies introduced in a coordinated way in EU member states, particularly those that are hard to implement effectively on a bilateral level. Promising candidates are taxes on cryptocurrencies, which are increasingly critisised due to their negative climate impact (Baer et al., 2023) or on aviation (Krenek and Schratzenstaller, 2017).[3] Statistical own resources similar to the plastic own resource (which is based on the amount of non-recycled plastic waste in member states) are also of interest, for example based on biowaste. They contain incentives to introduce measures at the member state level to decrease the respective environmentally harmful base (Büttner, 2023). New green own resources should – in addition to servicing NGEU debt – also be used to replace a part of current national contributions to the EU budget (Schratzenstaller, 2021). This would allow a reduction of the member states' national contribution and thus tax cuts at member state level, enabling a supranational green tax shift.

The greening of member states' tax systems would be supported by the revision of the EU ETD, which originally was envisaged for 2023, but is still pending. Accordingly, energy taxation shall be based on the energy content of the energy sources. Energy tax rates are to be increased stepwise between 2023 and 2033 and regularly adjusted for inflation. Moreover, sustainable energy sources shall be taxed at lower rates than non-sustainable ones.

Greening of EU expenditure

The second pillar of greening European fiscal policy is the greening of EU expenditure. The centerpiece of spending at the EU level is the EU budget in the narrower sense, i.e. the MFF 2021-2027. In addition, there is the COVID-19 Recovery Package NGEU, which was adopted in 2020 and is implemented as a temporary facility between 2021 and 2026.

The MFF is explicitly being used as an instrument of climate protection since the 2014-2020 programming period, by introducing climate mainstreaming – including a target of 20% of all expenditure for climate protection spending. The European Recovery Plan (i.e. the MFF and NGEU), provides for a climate mainstreaming target of 30% of total expenditure for the current MFF period. In addition, the do-no-significant-harm (DNSH) principle applies, according to which EU expenditure should not violate environmental targets. The climate protection target is supplemented by a biodiversity target, according to which in 2024, 5% of MFF expenditure is to be dedicated to the promotion of biodiversity, and another 10% in both 2026 and 2027.

The potential of the MFF to make an increasing contribution to climate protection is not being fully realised, however. According to the European Court of Auditors (2022), the actual contribution of the Common Agricultural Policy (CAP) in particular, but also of cohesion and infrastructure funding to the EU's climate targets in the last MFF period 2014-2020, was significantly below the stated values. At around 13%, the share of climate expenditure as a part of total expenditure fell significantly short of the climate mainstreaming target of 20%.

The CAP and cohesion policy are still dominating the current MFF, each accounting for about 30% of the total MFF volume. The European Court of Auditors (2022) expressed particular doubts as to whether the CAP, which is supposed to make the greatest contribution to climate protection, can actually achieve the targeted 40% climate protection expenditure. At the same time, the large volume of the CAP and cohesion policy severely constrains other areas of expenditure that could make important contributions to climate protection. This applies in particular to the Connecting Europe Facility (CEF), which among other things, finances cross-border infrastructure for transport and energy supply, whose share of expenditure has stagnated in comparison to the previous MFF. It also applies to the Horizon Europe research framework programme, whose share of expenditure has only slightly increased. Strengthening the impact of the MFF regarding the green transformation requires a reduction in the expenditure share of the CAP in particular in order to free up more funds for the CEF and the research framework programme (and here in particular for green research). In addition, the CAP and cohesion policy must be even more closely linked to climate targets.

Greening of EU governance

The green transformation is associated with challenges for EU governance, in particular with regard to fiscal rules (Pekanov and Schratzenstaller, forthcoming) and the European Semester.

To achieve the objectives of the European Green Deal, the European Commission (2021) estimates a green investment gap for the current decade of €520 billion per year (3.7% of 2019 GDP) compared to the previous

3 See Schratzenstaller et al. (2022) for a more detailed discussion of potential green own resources.

decade. A significant part of this green investment gap needs to be covered by the private sector. In face of its remarkable size, the remainder of the green investment gap will need to be financed by the EU and EU member states (Claeys and Tagliapietra, 2020; European Commission, 2022a). Hereby the existing EU fiscal framework acts as a constraint to the expansion of (debt-financed) green public investment at the member state level (Bénassy-Quéré, 2022). The proposal for the reform of the EU fiscal framework put forward by the Commission and currently negotiated at the EU level does not explicitly account for the increasingly pressing need for investment in climate protection and climate change adaptation measures. The current discussion should therefore seriously consider options to green the EU fiscal framework, e.g. a green golden rule, country-specific recommendations for green public investment via the European Semester, or an EU Climate Fund (Pekanov and Schratzenstaller, forthcoming).

The European Semester, which serves to coordinate economic, fiscal, labour and social policy within the EU, has been expanded in recent years from a relatively narrow focus on budgetary and economic policy to other policy areas. Currently, environmental aspects are primarily taken into account by monitoring the implementation of national recovery and resilience plans as part of the European Semester. Further steps in the ongoing efforts at the EU level towards greening the European Semester may include a regular monitoring of the development of the green investment gap, of environmentally harmful subsidies, and of a labour market policy adapted to the requirements of the green transformation (Simon et al., 2022).

EU green bonds

Green bonds are the fourth pillar of a European green fiscal policy. NGEU contains a commitment from the Commission to raise up to 30% (about €250 billion) of the funds borrowed on capital markets to finance NGEU via NGEU green bonds, making the EU the largest green bond issuer (Christie et al., 2021). Projects financed through the Recovery and Resilience Facility (RRF), as the core of NGEU, can be financed through NGEU green bonds if they contribute to climate and environmental objectives (such as biodiversity) and comply with the DNSH principle. This ensures that measures financed via green bonds support environmental objectives and do not significantly harm other environmental objectives.[4] The Commission has established the independently evaluated NGEU Green Bond framework[5] setting out the conditions for green bonds, which refer to the green expenditure categories for which green bonds proceeds may be used as well as the evaluation and selection, the tracking, and the impact reporting on the projects that may be financed through green bonds.

In a recent report, the European Court of Auditors (2023) criticises the fact that the Commission, in some cases, considered activities that do not meet the EU Taxonomy criteria to determine the contribution of RRF investments and reforms to the green transition. This implies that some share of green NGEU bond proceeds are not used according to the EU Taxonomy and the upcoming EU green bonds standard.[6] In addition, Commission reporting up until now does not include the actual amount of expenditure financed through NGEU green bonds aligned with the EU Taxonomy. Therefore, a stricter implementation of the NGEU Green Bond framework is called for. Generally, with increasing popularity of green bonds, the adoption of an official European green bond standard aligned with the Taxonomy currently under negotiation should be accelerated.

Conclusions

The greening of European fiscal policy can be expected to provide a powerful lever to support the European climate targets at the EU and member state level. To support and facilitate as well as to coordinate the greening of the four pillars of a European green fiscal policy outlined in this contribution, implementation mechanisms are required. These can build on existing institutional structures and mechanisms, in particular climate mainstreaming, green budgeting, or climate tracking. However, they need to be focused and strengthened to reinforce their effectiveness (Levarlet et al., 2022), and they should be embedded in the ongoing efforts to strengthen the EU budget's impact orientation. Moreover, greening efforts need a broader focus beyond climate change, considering also other important environmental problems, such as biodiversity loss. Not least, the greening of European fiscal policy needs to be accompanied by a comprehensive overall just transition strategy to avoid undesirable distributional effects and to secure public acceptance.

4 See Levarlet et al. (2022) for details.

5 https://commission.europa.eu/strategy-and-policy/eu-budget/eu-borrower-investor-relations/nextgenerationeu-green-bonds_en.

6 See Spinaci (2023) for a brief overview of the current status quo regarding an official European green bond standard.

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Towards a Common EU Debt: Where Do We Stand?

We are in a historical moment where Europe has reached a certain maturity in policy choices at the common level and has tested different policy instruments and interactions across countries. Without being an exhaustive list, the European Union and the euro area have experienced since the inception:

- common fiscal rules (the Stability and Growth Pact)
- the adaptation of state aid rules to crisis situations
- the resolution of several EU country crises during the sovereign debt crisis, with bilateral loans and supranational funding facilities (the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM))
- the start of the banking union (the Single Supervisory Mechanism and the Single Resolution Mechanism, although the European Deposit Insurance Scheme component is still missing)
- the implementation of unconventional monetary policy instruments, including what is often labelled “quantitative easing”.

The 2020-2021 pandemic crisis represented an inflexion point in supranational borrowing. With the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE) of up to €100 billion, and notably with the NextGenerationEU (NGEU) and its core component, the Recovery and Resilience Facility (RRF) of up to €723.8 billion, the EU has reached another milestone. Since 2020, the European Commission (EC), on behalf of the EU, began issuing EU debt on a large scale to fund these temporary programmes via grants and loans. These programmes were launched in addition to the long-term EU budget for 2021-2027 (€1,211 billion), which is funded via national contributions.

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* The views expressed are those of the author and do not necessarily represent the views of the European Central Bank or the Eurosystem.

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This has several implications. First, it is the first time that the EC aims at providing a joint fiscal effort on a meaningful scale, thus complementing the ECB’s monetary response to the pandemic shock. Second, this makes the EC a major (temporary) issuer of government borrowing in euros worldwide. This brings the EC into a prominent place in the landscape of supranational euro debt issuers, together with the EFSF/ESM and the European Investment Bank (EIB).[1] The NGEU programme could lead to a new net borrowing activity above €700 billion by the end of 2026. Third, this initiative provides a substantial amount of burden sharing between countries. There is a solidarity element for the first time with a substantial grant component (direct transfers) in the equation that could serve as a catalyst towards a common fiscal capacity if successfully implemented.

With the latest economic and geopolitical developments, there is a renewed interest by policymakers and academic researchers in the possibility of joining forces to go beyond the national goods to European goods. Moreover, the EMU is still incomplete, and the idea of a permanent countercyclical fund for shock absorption is still being debated. There are many angles to be analysed about the possibility of creating a permanent common fiscal capacity, ranging from the legal aspects to the political economic arguments and moral hazard. Much of the past debate has focused on the role of fiscal rules and fiscal discipline and the compliance with the SGP. Either way, further integration would require additional funding. According to one view, a possible roadmap might include the continuation in some form of the NGEU project beyond its end in 2026, towards a more permanent central fiscal capacity. This may play a role in enhancing macroeconomic stabilisation and convergence in the euro area in the longer run. This view, however, is not reflected in the current policy agenda.

Against this backdrop, this article explores some aspects surrounding the idea of EU borrowing. It first focuses on the concept of EU debt and then elaborates on some related concepts, including considerations around the guarantees and feasibility of a common EU debt. Third,

1 According to the European Court of Auditors (2023), the EC moved from the 15th largest debt issuers in the euro area in 2019 to 5th in 2021, only behind France, Germany, Italy and Spain. The EIB was 8th and the EFSF/ESM was 11th.

it points to some aspects relevant for the creation of a permanent common fiscal capacity, which would also entail the issuance of common EU debt. Finally, it then discusses what purposes could justify continued borrowing beyond 2026.

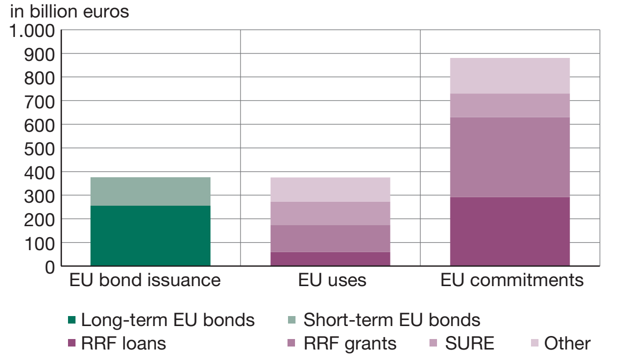
Common EU debt: Where do we stand?

The concept of common EU debt is an aggregated statistical construct obtained by adding the debt of individual member states. A key measure is the "Maastricht debt" (also known as EDP (Excessive Deficit Procedure) debt), which is the outstanding gross debt (defined as currency and deposits, loans and securities other than shares) at nominal value and consolidated between and within the sectors of general government (Lojsch et al., 2011). This covers the general government sector of the member states, intergovernmental lending and the EC as it possesses tax redistribution power and capacity to issue debt. The EC has been issuing bonds to support different EU policies for the last 40 years,[2] but it only became a prominent debt issuer as of 2020.

Figure 1

EU debt by the European Commission, 2020-2026

New bond issuance and uses (2020-2023) and commitments (2020-2026)



Notes: The cut-off date is 09/11/2023. Other refers to the aggregation of estimated resources to fund other programmes, e.g. NGEU's non-RRF, MFA, MFA+, and EFSM.

Source: Author's elaboration based on data from the European Commission.

On 22 October 2023, Eurostat published the aggregated EU debt, which amounts to €16 trillion or 91% of GDP (the euro area debt amounts to around €13 trillion or 90.9% of GDP). This figure accounts for loans provided by the EFSF/ESM to the beneficiary member states (i.e. Ireland, Greece, Portugal, Cyprus and Spain) and the RRF loans once payments have been finalised. Borrowing in the markets undertaken by the EC to finance the RRF grants is also considered EU debt.[3] However, the debt issuance associated with the past funding of the RRF grants is not reflected yet in the national and EU debt aggregates of 2021 and 2022, pending future Eurostat publications.

Focusing on the supranational new net borrowing activity from the EC, which is part of the EU debt, Figure 1 shows that around €375 billion have been raised from several new EU bond issuances over 2020-2023. This issuance activity compares with the €78 billion of new securities issued over 2009-2019. The EC has issued mostly long-term EU bonds (around 70%). The main uses of the common pool have been to finance SURE (€98.4 billion) and the RRF. The disbursement process is well on track as the member states are receiving their funds when requested. The disbursement proceeds from the RRF facility are directly transferred to the member states, while the non-RRF funds are transferred to the EU budget. The EC has already disbursed to EU member states around €174 billion, with around two-thirds of disbursements in the form of RRF grants. The main beneficiaries of the RRF funds by now are Italy (€85.4 billion), Spain (€37 billion), France (€12.5 billion) and Greece (€11.1 billion).

The NGEU programme (with a total envelope up to €806.8 billion, of which €723.8 billion constitutes the limit of the RRF) was designed with a RRF-grant element (up to €338 billion), a RRF-loan element (up to €385.8 billion) and a non-RRF element (€83.1 billion) to top-up other EU programmes (e. g. ReactEU). The actual amount of funds to be borrowed by the EC by 2026 for the RRF will depend on the final implementation of the Recovery and Resilience Plans (RRPs) by the member states. The most updated funding needs for the RRF are around €630 billion, after the call for requests for loans ended on 31 August 2023.[4] This is in addition to the NGEU's €83 billion contribution from the non-RRF programme. The EC average annual expected funding needs are still at around €150 billion

2 The EC has issued bonds to finance, among others, the Macro-Financial Assistance (MFA) programme with loans for non-EU countries, the European Financial Stabilisation Mechanism (EFSM) to support EU countries under financial stress, Balance of Payments (BoP) assistance for non-euro area EU countries with BoP difficulties. Since 2023, there is the new MFA+ which includes concessional loans for Ukraine.

3 It must be noted that the debt issued by the ESM is now recorded in the EU debt (and not in the rest of the world sector (S.212) as before). The EIB and the European Investment Fund are, however, classified outside the EU debt: they are classified within the financial corporations sector (S.12).

4 Out of €385.8 billion available for RRF loans, 76% have been committed, which has brought the total RRF loan requests to almost €293 billion. This is also the final amount of RRF loan requests, as, based on Art. 14(2) of the RRF Regulation, the loan requests had to be made by 31 August 2023. As a result, out of a total RRF envelope of almost €724 billion, €631 billion (87.2%) have been already committed: €338 billion in grants and €293 billion in loans.

per year until 2026. The amount that will finally be issued by the EC, whether to be disbursed to the countries via grants or loans, will increase the stock of EU debt aggregate going forward.

The economic case for common EU debt

There are several economic aspects regarding the feasibility of common EU debt.

Figure 2 summarises the solvency aspects of the EU debt linked with the temporary NGEU programme. The EU Treaties allow the EC to borrow from capital markets on behalf of the EU. This implies that the EC borrowing represents direct and unconditional obligations of the EU to service its debt. The EU's debt service is further guaranteed by the loan agreement, as the beneficiary member states have always been able to service their debt. Regarding the future repayment of the grant component, there is still a lack of clarity of which common resources will be raised at the EU level. However, there is a direct guarantee from the EU budget, as the EU is the ultimate guarantor of the EU debt. Moreover, the governments have committed to providing an additional ceiling of up to 0.6% of their national resources (gross national income) if additional revenues are needed.[5] This represents a contingent liability to the member states that ensures that the EU debt is viable. Overall, the borrowing activity of the EC is considered with a low risk of default.[6]

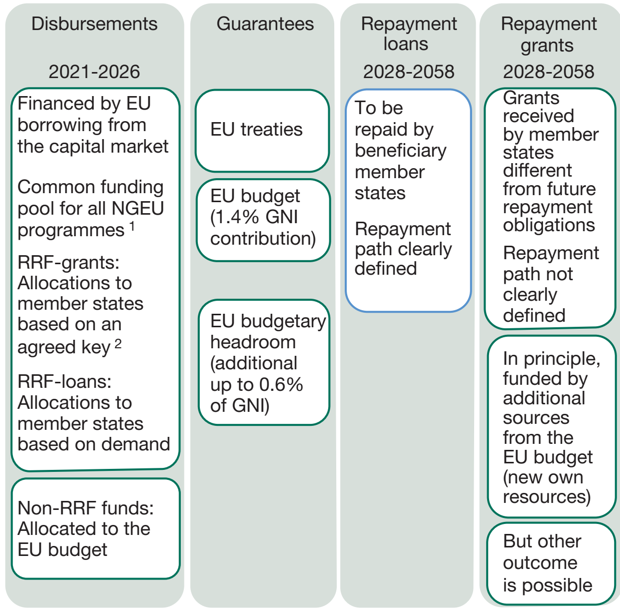
From an operational perspective, the EC moved from the back-to-back funding typically used to fund previous lending programmes to a new diversified funding strategy for the NGEU. The main difference is that it decouples the timing, volume and maturity of the borrowing transactions from the timing of the reimbursement of funds (European Court of Auditors, 2023). The rollover profile ensures a smooth repayment profile. Most of the debt to be issued will be long-term debt, and repayments (of debt and interest costs) are expected over 2028-2058. The final borrowing cost is unknown at the moment, but the prospects are good (e.g. Claeys et al., 2023), given some considerations: i) the cost of funding in the short term is increasing with the nominal interest rates, ii) the borrowing cost of

5 If there are difficulties in raising extra revenues during 2028-2030, when there is a peak of financing needs, then there might be a need to opt for additional avenues. Further options may include, for example, the reduction of other EU expenditures, the increase of national contributions (beyond the agreed limit of additional contributions up to 0.6% on GNI) or the reduction of the expenditure in the countries with high DSA risks.

6 The EU bonds have a high rating from the credit agencies, ranging from AAA (Fitch, Scope and DBRS)/Aaa (Moody's) to AA+ (S&P), all with outlook stable.

Figure 2

Key features of EU debt within the NGEU programme



Note: [1] The common pool of funding is EU borrowing to fund NGEU (RRF and non-RRF programmes), SURE, EFSM, BoP assistance facility, MFA and Euratom. The actual amount of funds borrowed by the Commission for the NGEU will depend on the final implementation of the RRPs by the member states. [2] Allocation key depending on change of real GDP in 2020 and 2020-2021, relative unemployment rate, population and reversed GDP per capita. The initial allocations of grants in 2021 have been slightly revised during 2022 based on the updated statistics for 2021.

Source: Author's elaboration based on publications from the European Commission and the European Court of Auditors.

the EU debt is still above that of Germany and France (but below that of Spain and Italy), and iii) the market liquidity of the EU bonds is not as high as, for instance, the German bonds. Some reasons might be linked to the defined duration of the EU bond issuance with a clear cut-off date by the end of 2026 and that investors may deter to include EU bonds in their long-term investment strategies (e.g. Bletzinger et al., 2023).

The current debate centres around the concept of debt sustainability analysis (DSA) and the ongoing European governance reform package, which also tackles the government debt angle. One of the expected consequences of the RRF design is that by improving, *ceteris paribus*, growth prospects and lowering the cost of financing (implying some interest savings), the RRF will help to somewhat mitigate debt sustainability concerns in vulnerable countries and may provide more fiscal space for economic stabilisation in the future (Freier et al., 2021). In the countries with high debt-related risks, it is also key with respect to reducing the stock of government debt through more favourable economic conditions and improved quality of public finances.

From the DSA perspective, country-specific concerns have improved in the highly indebted countries. The channels accounted for in the DSA are a combination of favourable risk premium effect, the impact of the fiscal stimulus on growth and inflation, and the effect of structural reforms on potential output. Overall, it is estimated to have the potential of reducing the government debt ratio by around 14 percentage points of GDP in Spain and 12 percentage points of GDP in Italy by 2031 (Bankowski et al., 2022). These favourable debt trajectories will depend on the future evolution of interest rates and on the timely and efficient implementation of the reforms and investment plans outlined in the RRPs.

Towards a permanent common fiscal capacity: Allocation vs. stabilisation

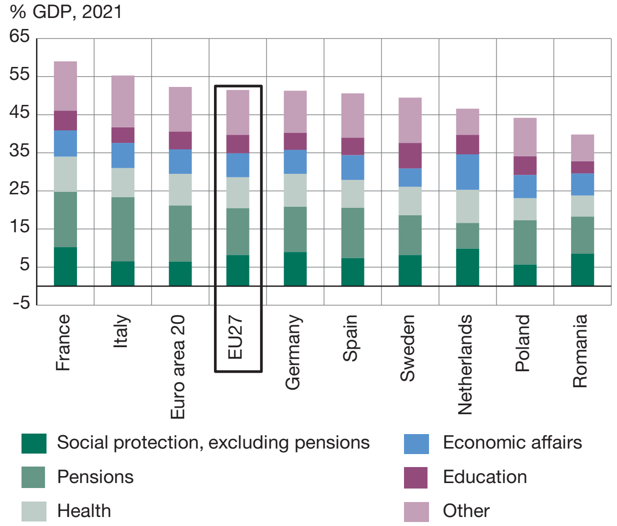
In brief, there are two main purposes for making the case for a permanent central fiscal capacity: allocation of resources and stabilisation of the economic cycle.

The temporary NGEU is a mix of both objectives, as its resources are mainly used to support structural reforms and the investment capacity towards the green and digital transitions (mainly via direct government investment and capital transfers to the private sector). The component of stabilisation comes from the possibility to respond counter-cyclically to an economic shock (e.g., the COVID-19 crisis or an energy shock). Moreover, the countries that were most hit, Italy and Spain, receive the most funds, pointing to an element of solidarity.

Currently, there is a discussion ongoing on the need for centralised financing of common EU investment needs (e.g. Panetta, 2023; Draghi, 2023). This could range from defence and migration to economic challenges such as ageing populations – with the associated costs in pensions and health care – or the centralisation of purchases of raw materials. A related concept is the European public goods (EPGs), that entails, among other features, both common EU financing and the joint production of goods (Buti et al., 2023). The experience of the NGEU shows that less than 5% of the investment projects are cross-national in nature: in other words, the projects funded by the EU are mostly nationally produced and, therefore, would not qualify for EPGs.

The key question is whether we could converge towards the provision of more common public goods. European governments spend, on average, the highest amounts of

Figure 3
Where do EU governments spend their national budgets?



Notes: Other includes the remaining economic activities, namely general public services, military expenditure, public order and safety, environmental protection, housing and community amenities, and recreation, culture and religion.

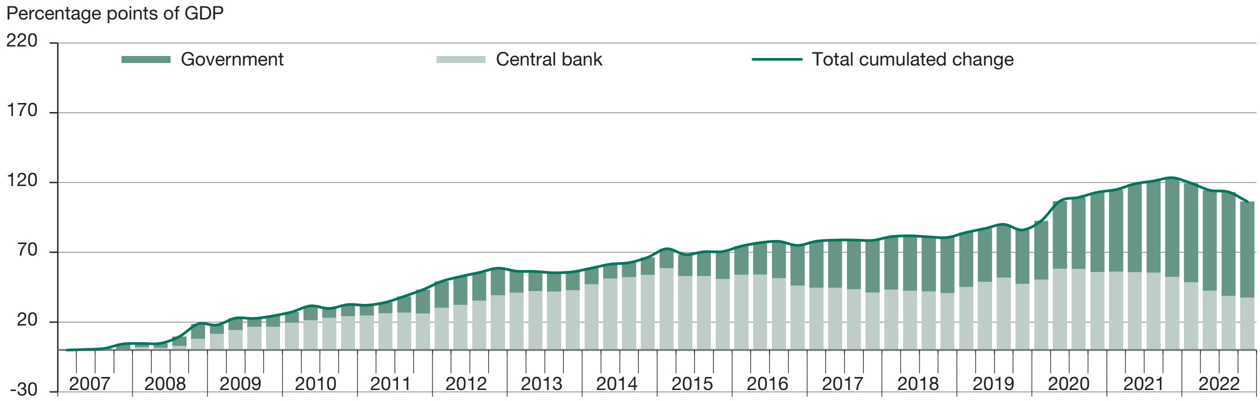
Source: Author based on COFOG data (Eurostat).

funds in the world (in percentage of GDP) for the provision of public goods and services. Yet, there are different preferences and fiscal capacities. Figure 3 shows how the EU, the euro area and selected countries spent their budgets in different economic functions. The main function is redistribution, with social protection (including pensions) being the largest component of public expenditure in all countries, amounting to 21% of GDP on average. Pension payments represent around 60% of this expenditure on average. Other priorities (although with different national preferences) are health, economic affairs and education. In contrast, most of countries spent the lesser resources in defence (1.3% of GDP) and environmental protection (0.9%) in 2021. Some of these goods and services could be eventually brought at the European level, with the subsequent issuance of more common EU debt.

On the other hand, a permanent fiscal stabilisation capacity is still missing in the Economic and Monetary Union (EMU) architecture. The idea put forward by several researchers and commentators is to introduce a permanent countercyclical central capacity to respond in cases of economic country-specific shocks – or common shocks with asymmetric effects across countries – when national fiscal stabilisers are impaired or when countries face difficulties to

Figure 4

Increase of leverage in the euro area by contribution, governments and central bank, 2007-2022



Source: Girón and Rodríguez-Vives (forthcoming).

borrow on financial markets (e.g. Beetsma et al., 2021). This concept has been largely debated in academia and in European fora, with contributions from the macroeconomics and political economy literature. The discussions on the trade-offs of a permanent common fiscal capacity and its optimal size are beyond the scope of this paper, but some momentum might emerge in view of the recent developments. Regarding the potential moral hazard argument, a push factor would be the implementation of an improved fiscal governance framework in the EU as of 2024. Concerns over the possible generation of permanent transfers among countries, could be partly alleviated by the NGEU programme being a success story and by introducing safeguards in the design of the central fiscal capacity itself. For example, transfers – for each country – could be calibrated to deviations from historical growth, not on growth differences between countries (see, e.g. Beetsma et al., 2022). The non-repayable part (transfers) constitutes around half of the total envisaged NGEU envelope, which implies a step forward in cross-country risk sharing at the EU level. A possible permanent common fiscal capacity would likely be limited to euro area countries, instead of the EU. One of the main arguments is that euro area countries do not have the possibility to use their national currency to devaluate in case of major economic shocks.

Finally, another related important angle is the role of the central banks as lenders of last resort, which is explained in Girón and Rodríguez-Vives (forthcoming). Figure 4 shows the combined leverage response in the euro area over 2007-2022. It is clear from the figure that the contribution of the Eurosystem to the combined euro area fiscal-monetary policy response (measured in leverage) has increased over time. The ECB has supported the ability of national fiscal policies to stabilise the cycle beyond automatic stabilisers in the presence of increases in sovereign spreads.[7]

Conclusions

A precondition for thinking beyond the 2026 deadline for more EU common debt would be that the NGEU programme is perceived overall as successful from different perspectives, ranging from the operational borrowing performance to the materialisation of the macroeconomic expected impacts.

The effectiveness of the NGEU will crucially depend on a timely and effective implementation of the RRPs. However, it is too early to assess the implementation. Implementation risks relate to possible lower-than-expected absorption capacities, with the substitution of productive investment expenditure with consumption/social expenditure, or the possibility that the investment targets are not fully met by 2026. A careful monitoring and implementation of the reporting and review mechanisms in place at the European and national level is key for the success of the NGEU project. The European Court of Auditors has been relatively positive in its initial assessment over the 2021-2022 implementation. In 2024, there will be an audit to assess the mid-term review of the programme, which will be key for public trust in this novel policy instrument.

7 For instance, the public sector purchase programme initiated in March 2015 implied the expansion of the asset purchase programme that started in 2014. See https://www.ecb.europa.eu/mopo/implement/app/html/index.en.html.

In view of the current developments, choices on how to better allocate public resources are becoming even more crucial. New economic and geopolitical challenges are impacting national and EU budgets (e.g. digitalisation trends, climate change, deglobalisation trends, defence expenditure, war in Ukraine), while several countries face increasing challenges (e.g. immigration, energy supply costs, high stock of debt, ageing populations). Looking ahead, the urgency of further sharing the public goods and burdens across EU countries may increase. Moreover, the higher frequency of economic shocks may justify the room for a permanent joint rainy fund and accelerate the process of completing the EMU.

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Tax and Debt Financing the EU

EU financing can in principle draw from two sources – from "own resources" as well as from "other revenues".[1] No binding definition exists as to what kind of resources can qualify as own resources. With no substantive limitation, own resources can draw from various sources. In the past, member state contributions were the predominant sources, while EU taxes or borrowing are increasingly taking centre stage. This article addresses both – taxes and borrowing – and emphasises the legal leeway and limitations on using these financial resources for the EU budget.

The claims put forward in this contribution relate to the suitability of taxes and borrowing to finance the EU budget. First, not only does the EU have limited taxation power and there is no taxation power falling into its competence for public finance purposes; most tax proposals currently envisaged as own resources create "unreal" tax revenues on the basis of statistical values which cover the fact that they are nothing other than ordinary member states' budget contributions running under the fake title of a tax. Second, repeating off-budget EU borrowing akin to NextGenerationEU (NGEU) is generally possible but faces the constraint that the space for additional EU borrowing is limited until NGEU repayments have brought "other revenue" back to magnitudes that are only marginal in relation to the amount of "own resources". Third, EU borrowing on-budget for the EU budget would be unprecedented but possible, though with severe limitations, in particular associated with the requirement that all debt service having to do with EU borrowing must be backed, by legal requirement, by unconditional non-borrowed own resources.

Real versus unreal EU taxes

With respect to taxes, a distinction must be made between taxes identified as "own resources" in the Own Resource Decision (ORD) and taxes that are actually implemented (at the EU level or at the member state level). This distinction is important because the "own resources" (the current as well as probably much more future ORDs) draw from "imaginary", statistical-based taxes that oblige member states to pay the EU a virtual tax from their national budgets without this tax actually being implemented. In order to avoid misunderstandings, one should therefore distinguish between *real* und *unreal* taxes.

By real taxes, I refer to taxation power that is backed by an actual EU competence to tax or by a specific member state tax which is then passed on to the EU budget. There is indeed leeway for the EU to implement environmental taxes[2] as well as energy-related taxes.[3] But these tax regimes are not taxes that can be raised for public finance purposes – they are tied to environmental or energy objectives. In other words, these taxes cannot be raised in order to finance the EU budget – this function can only be a side effect of the primary policy-specific purpose of these taxes. The same applies to the EU's powers related to the internal market: the EU is allowed to harmonise taxes if this is necessary for the establishment and functioning of the internal market or required in order to eliminate distortions of competition in the internal market. Again, this cannot serve the EU to pursue public finance purposes. It is only permitted if harmonisation primarily pursues this objective.

"Unreal taxes" can be referred to as those identified as "own resources" – statistical-based revenues that determine the amount that member states must transfer to the EU budget. These sources are not necessarily levied in practice. Take the "plastic tax", which is currently an "own resource" to the 2021-2027 EU budget – it is a statistical-based tax which many member states do not implement. The tax revenue of the plastic tax is hypothetically computed and member states pay this national contribution to the EU from their domestic budgets. The same applies to the various other tax revenues that have been in the policy debate, such as a new corporate tax based on operations and levied on companies.

The tax policy debate on "own resource" is thus a "ghost debate" in a certain way – it introduces imaginary taxes for which the EU has no compentece and which the EU cannot oblige member states to implement. The invention

1 Article 311 of the Treaty on the Functioning of the European Union (TFEU).

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* Some elements of this article build on Grund and Steinbach (2023).

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2 Article 192 para. 2 subpara. 1 a) TFEU.
3 Article 194 para. 3 TFEU.

of statistical-based taxes for the purpose of generating "own resources" is even misleading to the extent that they engender tax increases other than the one for the "own resources". This is so because a statistical-based own resource implies an increased transfer in the national contributions to the EU budget, for which each member state has to find financial cover. Practically, this implies that member states must consider domestic tax increases to ensure the transfer to Brussels (unless they are able to cut other expenditures).

Overall, the tax revenue debate for "own resources" should acknowledge that we are not talking about genuine EU taxes, nor do we necessarily talk about taxes that are actually implemented. The Union is not able to raise taxes for the purpose of budget financing (hence to finance the EU budget). The few tax powers the EU has are confined to their purpose to deal with sectoral policy objectives (i.e. climate, energy). Drawing from these sources for the purpose of "own resources" must remain a side benefit of sectoral taxation.

Repeating NGEU

From taxes, we turn to debt as a funding source for the EU budget. Two possible avenues for debt financing of EU public goods can be distinguished. First, debt financing can be used for the purpose of repeating a temporary, "one-off" and "off-budget" fund like NGEU that was set up to borrow (and spend) for a specific purpose. Second, we look into the EU engaging in borrowing in order to fund the regular EU budget, hence creating a permanent, "on-budget" debt-financing capacity. While this avenue has been used on various occasions in the past (basically for back-to-back lending operations), allowing debt as an own resource would be a major innovation under EU budget practice. This has occassionally been employed on a small scale by exploiting the budgetary headroom or margin under the EU budget, although only featuring a back-to-back funding mechanism (the European Financial Stability Mechanism is the most important example).

NGEU was built on unprecedented legal architecture that engaged the issuance of bonds with a quasi-mutualiasing effect, which had previously been ruled out given its distributive nature. There is no general barrier to adopting an NGEU-type approach for the purposes of financing specific future expenditures of the EU. This would require an amended ORD, which would authorise borrowing up to a maximum amount and for a specific purpose, and adjust the own resources ceiling to ensure that borrowing can be repaid.

However, repeating NGEU meets at least two limitations. The first barrier results from the Treaty's expectation that own resources are the primary source for financing the EU. As mentioned above, there are in general two sources – "own resources" and "other revenues".[4] NGEU was introduced as "other revenue" off-budget and as externally assigned revenue into the EU finances. The primacy of "own resources" as the main sources of revenues would be challenged if a large and increasing portion of EU expenditure were to be financed off-budget via "other revenues", including borrowing, rather than "own resources". Put differently, "other revenues" must be small in relation to the own resources. A budgetary framework in which off-budget financing in the form of other revenue exceeds the financing from own resources would not comply with this requirement of the Treaty – no matter whether the economic purpose supports off-budget expenditure. Given the sizeable magnitude of off-budget NGEU resources, the expectation of the legal requirements is that other revenues will decline to a fraction of own resources until NGEU is repaid entirely in 2058. Against this background, while repeating NGEU is generally possible, doing so in the near future would significantly reduce the permissible amount of off-budget borrowing (given the still existing amounts of NGEU funds).

The legal requirement of "other revenues" to be only a fraction of the budget has been articulated by the German Constitutional Court. Some are tempted to argue that it is only the European Court of Justice (ECJ) that gives authoritative interpretations of EU law (which is formally correct), and thus one should ignore the interpretation of a domestic court. This attitude – which seems popular among those fed up with a German court that constantly opposed the various anti-crisis measures adopted in the Economic and Monetary Union in the past decade – would be disregarding the political repercussions. A German government that is bound to both the rulings of the ECJ as well as the domestic constitutional court would find itself in an extremely precarious situation, and the spillover effects for Europe are certain to be negative. As long as the ECJ itself has not ruled on certain Treaty provisions (such as the relationship between "other revenues" and "own resources"), there is (political) wisdom in paying attention to the concern expressed by national constitutional courts. Consequently, if the NGEU model were to be replicated to finance public goods in the coming years – as proposed, for example, by the European Central Bank in the form of an EU Climate Fund – the quantitative limit becomes binding, leaving only limited space for debt financing programmes for the budgetary period.

4 Article 311 TFEU.

The second point of contention is the “exceptional” character of NGEU. The “exceptionality” and the “temporary” character of NGEU were explicity stipulated in the current ORD. In the case of NGEU, the exceptional character was built on solidarity to respond to the uneven effects of the COVID-19 shock on member states (which legally translated into the use of the infamous solidarity clause of Article 122, which gives member states much leeway and circumvents the European Parliament). One question that lawyers have been discussing is whether repeating NGEU would again be linked to a solidarity situation such as the pandemic. However, there are convincing reasons to distinguish between the revenue and the spending side.

The *revenue* side is secured through the ORD – creating “off-budget” external revenues (within the quantitative limitations mentioned above), which require unanimity in the Council and even member states’ ratification (i.e. through many national parliaments). For the *expenditure* side, it is not strictly necessary to limit a possible NGEU-successor to a solidarity-scenario akin to NGEU. This is in line with the previous borrowing practice of the EU: in borrowing for back-to-back lending for member states, the EU used a plethora of different justifications in addition to solidarity and emergency scenarios. Clearly, the EU is not entirely free to choose how it intends to use the revenues that it borrows. It must strictly apply with the legal core “principle of conferral”, which allows the EU to act only where it has a legal basis in the EU Treaties. There is a number of possible policy fields where the expenditure could be used to attain policy objectives – for example, in the area of cohesion policy,[5] for environmental purposes,[6] for transnational infrastructure,[7] or for trans-European research.[8] Programmes pursuing objectives of cohesion akin to macroeconomic programmes addressing cross-border cooperation may be considered more generally as the climate emergency or environmental spending programmes.

Debt financing as an own resource?

Thinking one step further means considering an unprecedented move: allowing debt financing to be integrated as revenue into the general EU budget rather than borrowing funds for specific purposes as off-budget “other revenue”. While borrowing under the EU budget is not a new practice, scholarship and jurisprudence are divided on whether the EU may finance its *general* budget with debt. There are good arguments to consider EU borrowing for the general budget to be compatible with the legal requirements, but there are also legal risks associated with it (just the same way as many European institutional innovations such as building an European Stability Mechanism or setting up NGEU came with residual legal risk). These risks can be mitigated by a restrictive practice of allowing borrowing.

Specifically, the Treaties neither deny nor explicitly empower the EU to finance its budget with debt. While the ORD and the EU Financial Regulation reflect the preferences of the EU legislators at the time of their adoption, it is undisputed that the Treaty does not contain an *absolute* prohibition against raising debt. The EU would need to add a new category of own resources in the ORD that allows borrowing. Also, there are in principle no quantitative limits on borrowing, but two major limitations impede the use of debt proceeds as own resources.

First, the EU must have adequate means to meet its debt service in any year, which must be secured by a sufficient amount of (non-borrowed) own resources. This flows from the Treaty-based balanced budget requirement. To that end, given that borrowed money does not become own resources indefinitely, there must be a safeguard to ensure the repayment of the debt. Thus, there is a need for a counterbalancing asset in order to ensure such a “irrevocable, definitive and enforceable guarantee of payment” (Council Legal Services, 2020) provided by the member states. What matters is budget neutrality – the resulting debt must be matched by a claim allowing the Union to cover the debt service. This must be ensured through definite, non-borrowed own resources – the EU must, for example, increase the amount of the GNI-ceiling in order to guarantee a balanced budget every year.

Second, the ORD, which requires ratification by all EU countries, must specify the permissible amount of borrowing. When the proceeds of debt financing become a new category of own resource, there is no other way than regulating the amount that will be issued in the ORD. The upfront specification is necessary for two reasons: in order to determine the precise amount of guarantee that is necessary to back “borrowed own resources”, and in order to satisfy domestic (e.g. German) requirements emphasising that any financial transfer from a domestic to the EU budget must be *ex ante* foreseeable and quantifiable.

Borrowing on the regular budget rather than off-budget can build on several further advantages. The European Parliament is directly involved as co-legislator und must approve the EU budget – “on-budget” constructions thus enjoy greater legitimacy than “off-budget” solutions. On-budget solutions are fully transparent and subject to oversight by

5 Article 175 TFEU.
6 Article 192 TFEU.
7 Article 171 TFEU.
8 Articles 179 and 173(3) TFEU.

the European Court of Auditors. Finally, not only EU level legitimacy would be ensured through the European Parliament, but also national parliaments would remain in full control of the EU's revenue from borrowing operations via the ORD. With the Commission tied to the *ex ante* defined borrowing in the ORD, member states have full foresight of the risk that they subscribe to with the budget.

Economists are fond of revolving debt, and the question here is whether outstanding EU debt may be refinanced by issuing new EU debt. Under NGEU, the EU is not allowed to roll over debt, with the legal authorisation only empowering the raising of debt for the specific purpose described in the ORD. Whether this would be possible with respect to borrowing proceeds that are categorised as own resources is less clear and poses difficult legal questions. However, with the maximum possible borrowing specified *ex ante* in the ORD, revolving debt appears possible. What matters from an EU primary law perspective is that member states create sufficient non-borrowed own resources to repay the liabilities.

Finally, what can debt-financed "own resources" be spent on? Different considerations apply for on-budget EU debt than in the case of funding off-budget debt. Unlike off-budget debt, there is no strict requirement for earmarking expenditures. Rather, the budgetary universality and non-assignment rule applies, which means that revenues shall be used without distinction to finance all expenditure entered in the Union's annual budget. With this core budgetary principle, EU-borrowed funds can generally be spent on any budgetary item, provided that the expenditure is in line with an existing EU competence (as it is required for all EU expenditure irrespective of the funding type). However, one could generally consider an earmarking of on-budget debt-financed expenditure. This could be a sensible option in view of the German Constitutional Court's reservation to acknowledge that EU debt can finance the general EU budget. In order to accommodate the restrictive perspective, the EU budgetary lawmakers would need to lift the universality principle in order to allow for an earmarking of EU debt.

Conclusions

The policy debate on own resources does not lack creativity in identifying possible financial sources. However, the identification of tax instruments seems particularly misleading, because of its insufficient distinction between "unreal" and "real" taxes, with the former determining hypothetical statistical-based taxes for which the EU has no authority to collect, nor can the EU require member states to implement these taxes. These taxes imply a tax collecting and public finance power that does not exist. In fact, the EU has very limited taxing power, and no authority to tax for public finance purposes. Rather than creating new "unreal" taxes, the debate should focus on which genuine taxing powers the EU should gain for public finance purposes. That goes beyond singular sectoral taxing competences such as in energy and climate, and makes Treaty changes indispensable.

In turn, the debate can benefit from more creativity with respect to debt-financing the EU – this contribution highlighted leeway and limitation of replicating NGEU and debt-financing the regular EU budget. Repeating NGEU for other purposes requires an amendment to the ORD to borrow other revenue (external assigned revenue) and create an off-budget item. Unlike for the pioneering NGEU, a replication would face significant size restrictions. "Other revenues" must be marginal compared to "own resources" in order to comply with the EU legal framework, which makes a repetition of this instrument in the near future unlikely because NGEU debt must converge towards marginality in relation to own resources. Any future NGEU-like fund must likewise demonstrate it is a one-off and temporary measure.

Debt-financing the regular budget is not per se prohibited. Clearly, a new ORD would have to be adopted, with the legitimacy enhancing requirements accorded through unanimity and national ratification, and with the involvement of the European Parliament, unlike under NGEU-like off-budget solutions. However, the economic potential of borrowing for the EU budget would be severely impaired by the limitation that all debt service arising from the borrowing must be backed by non-borrowed own resources (e.g. through an increased GNI-ceiling like under NGEU) as well as by the predefined maximum amount of borrowing.

Spending is subject to less constraints than funding. Certainly, repeating NGEU would need to comply with the exceptional and temporary character of off-budget constructs and using the borrowing exclusively for predetermined purposes is indispensable. There is more flexibility under on-budget debt. All EU expenditure must comply with EU primary law, which suffices as a limitation to expenditure. Alternatively, if politically desired and in order to address remaining legal concerns, the earmarking of borrowed debt to certain on-budget EU expenditure is feasible.

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JEL: H63, H61, G28

Kalin Anev Janse

Developing European Safe Assets

Safe assets rank as the most assured and reliable securities, commanding the highest credit ratings, and are a key component in a well-functioning capital market. Safe assets are critical for economies and their existence is especially welcomed in capital markets in times of market stress or uncertainty.

They are typically associated with three fundamental characteristics (Gorton 2017, Brunnermeier et al., 2016, 2017, Brunnermeier and Huang, 2018, Gorton and Ordonez, 2022): a high credit worthiness (asset "quality"), an ability to retain value in the event of adverse market price movements ("robustness") and a strong liquidity profile ("liquidity").

Thanks to these characteristics, market participants can use safe assets as a refuge in the event of market turmoil, as collateral in financial transactions, as a risk management instrument or as a reference for pricing other financial securities.

The European safe asset base includes government bonds from the highest rated euro area countries, as well as bonds issued by European supranational institutions that are backed by the European Union or euro area countries. German Bunds naturally form the first level of safe assets in the euro area. They are complemented by government bonds from euro area countries with ratings similar to those of Germany.

Bonds issued by European supranational issuers – the European Investment Bank (EIB), the EU, the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) – are part of this European pool of safe assets. They were created to respond to the various challenges Europe experienced. They are part of what markets define as the European safe assets.

The creation of the European safe assets stems from the important role that a deep safe asset base contributes to financial stability in times of crisis, such as the global financial crisis and the European sovereign debt crisis. We witnessed the positive market impact that the creation and usage of safe assets had (Figure 1). The creation of the EFSF in 2010 as well as the ESM in 2012 and the financial assistance programmes of these two institutions, combined with the European Central Bank (ECB) response, helped to reassure the market. This was manifest with reduced bond yield spreads relative to Germany in several euro area countries. The EFSF, the ESM, and the coordinated policy response with the EU, ECB and International Monetary Fund contributed to this success. During the COVID-19 pandemic, the initial €540 billon policy response of the ESM, the EIB and the EU, followed by the €800 billion NextGenerationEU (NGEU) post-pandemic recovery vehicle further eased upward pressure on euro area countries' bond yield curves.

As Figure 1 shows, the financial markets punished the absence of shock absorbers in Europe. But by 2015, when Greece needed more financial assistance, which the ESM provided, it was evident that even ten-year Greek government bond spreads versus German Bunds were less than half of those experienced five years earlier. By 2020, when the pandemic became a common shock for Europe, Greek government bond spreads widened even less. Over time, Europe's financial architecture reassured markets, and we see less volatility and narrower spreads. Europe was able to calm markets.

History of European safe assets

The EIB created the first European safe asset. It was founded in 1958 by the Treaty of Rome and was granted permission to issue bonds. From 1961 – when its initial loan of 20 million guilders was floated on the capital market of the Netherlands – to 1972 (just before the first enlargement of the European Economic Community), the EIB issued 99 loans for an equivalent amount of almost €2 billion (Bussiere et al., 2008). Initially, the EIB was backed by the six founding members: Luxembourg, Belgium, the Netherlands, Italy, France and Germany. Today, the EIB has 27 shareholders – the 27 member states of the EU.

The second European safe asset came from the EU. It issued several community bonds on private markets since the 1970s, which were guaranteed by the member states and distributed to countries where required (Meyer et al. 2020). The first European Community bond was issued in 1976 and used for Italy and Ireland.

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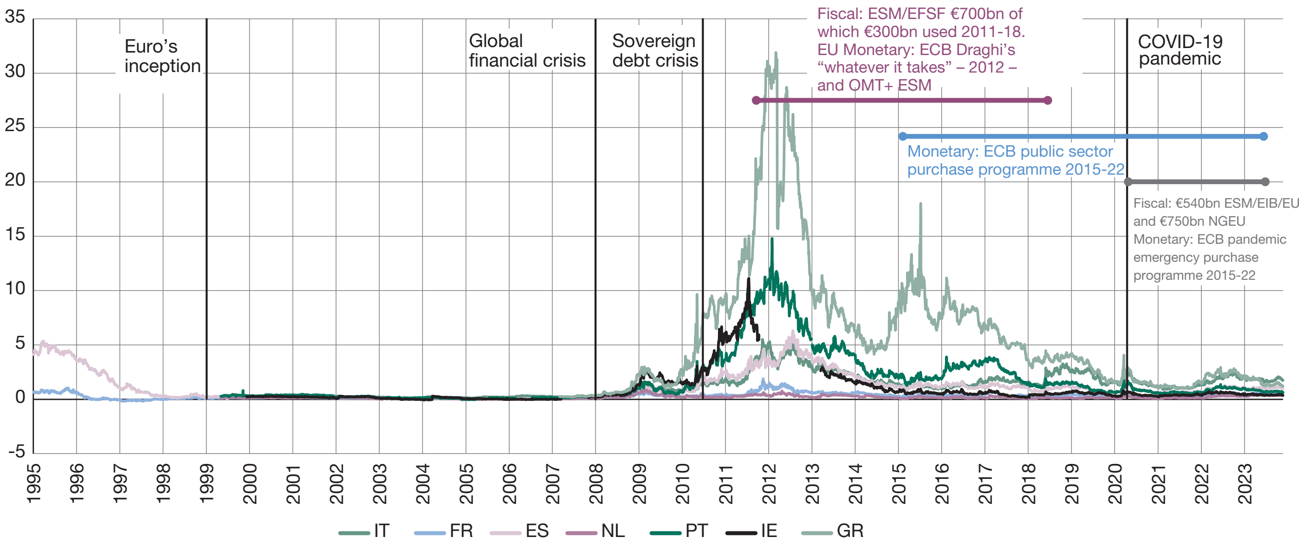
Kalin Anev Janse, European Stability Mechanism, Luxembourg, Luxembourg.

Figure 1

Yield spread evolution of euro area sovereigns against Germany

Percentage points, 1 January 1995 - 22 November 2023



Source: Bloomberg, ESM.

The third European safe asset issuer was the EFSF, which was created in 2010 as a response to the global financial crisis and the European sovereign debt crisis. The EFSF issued its first bond in 2011 for the Irish adjustment programme.

The fourth European safe asset issuer was the ESM. Founded in 2012, the ESM issued its first bond in 2013 for the Spanish bank recapitalisation programme.

Comparison of European safe assets

The four European supranational issuers have different institutional bases (see Table 1). The EFSF is a private company under Luxembourgish law owned by the 17 countries of the euro area upon its creation. It excludes Latvia, Lithuania and Croatia, who joined the currency bloc later. The EFSF has very limited capital, and its bonds are backed by explicit guarantees of the 17 countries. The six best credit-rated euro area countries (Luxembourg, Finland, the Netherlands, Germany, France and Austria) over-guarantee up to 165% in order to ensure a safe asset status and high credit rating.

The ESM is an inter-governmental institution under international law. It has a paid-in capital of €80.5 billion and callable capital of €624 billion. It is owned by the 20 countries of the euro area.

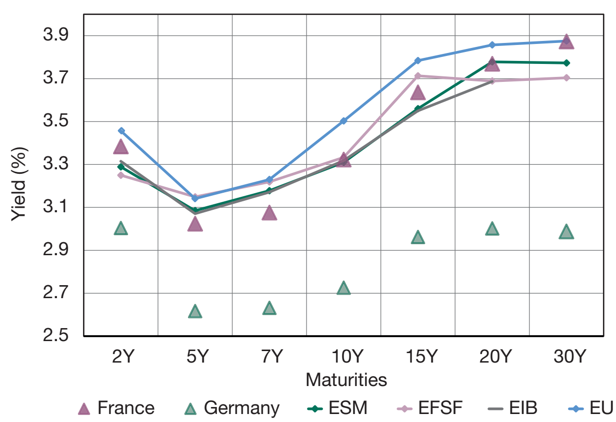
The EIB is owned by the 27 EU member states. Its paid-in capital is €22 billion, and it has €227 billion of unpaid subscribed capital. The EU is backed by its 27 member states, and it has no paid-in capital. The EU borrowing is guaranteed by the EU budget.

The four European supranational issuers accounted for almost €1 trillion in euro-denominated bonds and notes as of 6 November 2023. The EU, with €431.3 billion was the largest, followed by the EFSF/ESM with €276.7 billion and the EIB with €250.7 billion. The four European safe asset issuers price close to the strongest European sovereigns. They include a market premium compared to Germany and are close to France (Figure 2).

Figure 2

Yield curve of the four European supranational issuers versus Germany and France

As of 6 November 2023



Source: Bloomberg, ESM.

Table 1

Comparison of the four European supranational issuers

	European Financial Stability Facility	European Stability Mechanism	European Investment Bank	European Union
Ratings	Aaa/AA/AA-	Aaa/AAA/AAA	Aaa/AAA/AAA	Aaa/AA+/AAA
Ownership	Private company under Luxembourgish law owned by the 17 euro area member states at the time of EFSF creation	Inter-governmental under international law owned by the 20 euro area member states	Owned by 27 EU member states	Owned by 27 EU member states
Guarantee	Explicit	Implicit	Implicit	Implicit
Subscribed capital paid-in	€745mn	€81bn	€22bn	Non applicable
Subscribed capital unpaid	Non applicable	€624bn	€227bn	Non applicable
Risk weighting	0%	0%	0%	0%
Liquidity coverage ratio	Level 1	Level 1	Level 1	Level 1
Purpose	Limited to rolling over maturing debt (outstanding loans €172.6bn: 76% GR, 14% PT, 10%IE)	Permanent institution, to enable countries of euro area to avoid/overcome financial crises	To support investment in infrastructure projects, and SME development, and to mitigate the effects of global warming	To support recovery from the COVID-19 crisis and investments into a sustainable economy
Eligible for the public sector purchase programme	Yes	Yes	Yes	Yes
2023 funding (estimates)	€20bn (liquid benchmark bonds, up to 2056, private placements)	€8bn (liquid benchmark bonds EUR, USD, maturities 1 to 45y, private placements)	Up to €50bn (mainly EUR, USD, 3-5bn size, benchmarks 2-30y, green bonds)	€170bn borrowing authorisation for the year (liquid bonds from 3y, 30% green format)

Sources: EU, EIB, ESM.

The longest established issuer, the EIB, has the tightest market pricing. It is followed by the European Stability Mechanism – with a strong capital base – and the EFSF. The EU trades the widest among the four issuers since the introduction of the NGEU vehicle.

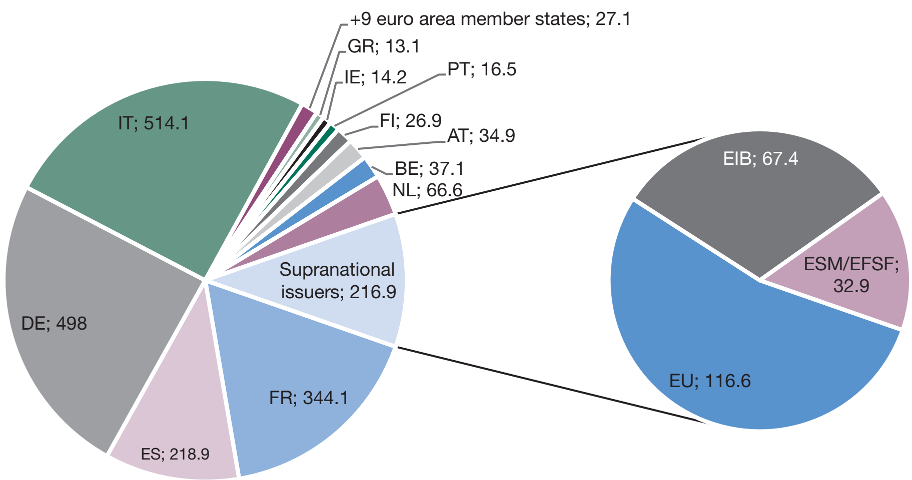
In terms of market liquidity, the government bonds issued by Italy, Germany, France and Spain are the most liquid ones. The European safe assets are fifth in terms of liquidity. Figure 3 displays daily average traded volumes for the main government and European safe assets.

It is worth noting the difference between highly rated government bonds and the ones from the four European supranational issuers. The latter have an insurance component to break the link between sovereign and banking

Figure 3

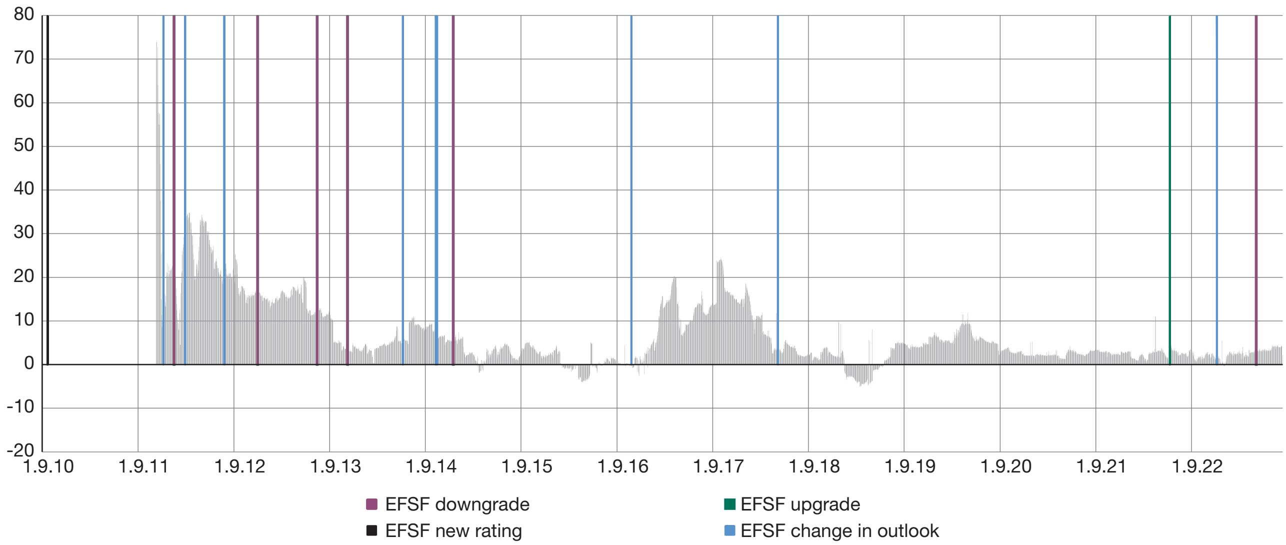
Market liquidity: Daily average traded volumes for European safe assets versus the main euro area government bonds

in billion euros



Sources: AFME, Finbourn, October 2022.

Figure 4
EFSF yield spread versus EIB through rating agencies decisions on EFSF
EFSF-EIB yield spread (basis points)



Sources: Bloomberg, ESM.

risks and allow a safe harbour for flight (Brunnermeier et al., 2011, 2017). This led to the proposal of the creation of European Safe Bonds (ESBies). Papadia and Temprano Arroy (2022) take it a step further and state that safe assets labelled in euro are critical for creating deep banking and capital markets unions. They also illustrate how far we have progressed already in European supranational bonds.

The size of European safe assets has been increasing over time, and this accelerated during the pandemic with the introduction of the NGEU vehicle. We have come some way in establishing European bonds as benchmarks and large investment assets with blended risk.

Markets' appreciation

Developing a safe asset status takes time. When the EFSF was created, it traded 75 basis points above EIB in its early years, as shown in Figure 4. The EFSF follows closely the rating of France and has gone through similar upgrades and downgrades over the last decade. Over time, the market started recognising the EFSF as a European safe asset. Despite the upgrades and downgrades, the EFSF converged to the price of the EIB. Over the years, the spread came down to 25 basis points and now the price is similar with moments where the EFSF goes through the curve of the EIB.

This shows that the market – despite the volatility and different ratings, mandates and capital structures – sees these European issuers are safe assets.

We have seen a counter-intuitive phenomenon in the European safe assets since the beginning of 2022. Despite the high ratings and good liquidity profiles of the European safe assets, their yield spreads relative to Germany widened significantly. However, this trend reversed somewhat in 2023.

These developments are the result of a number of factors, the effects of which need to be curbed to ensure that they do not lead to increased fragmentation and price distortion within the European safe asset base.

From a conjunctural perspective, the reduction of ECB bond holdings in the context of Quantitative Tightening has disadvantaged European supranational issuers more than sovereigns in terms of yield trends. Indeed, during the quantitative easing phase of ECB monetary policy, the ECB was able to purchase up to 50% of each outstanding bond line from supranational issuers, whereas this ceiling was limited to 33% in the case of sovereign bonds. The ECB Pandemic Emergency Purchase Programme (PEPP) came on top of these numbers. Quantitative tightening is now leading to a faster increase in free float for supranational bonds than for sovereigns, pushing their yields higher.

Additionally, the heavy bond supply from the EU to finance the €100 billion SURE and €800 billion NGEU programmes has pushed yields of the four supranational issuers higher. Given its relative weight in the supranational market segment, the EU has indeed become the main driving force for yield spreads of the European safe assets. The EU has repeatedly secured a substantial order book with a high issuance premium. This has added to upward pressure on yields in the supranational market segment as a whole.

A number of structural factors also explain the yield trends that have been at work since the beginning of 2022 within the European safe assets pool.

Firstly, the ECB's new anti-fragmentation tool, the Transmission Protection Instrument (TPI), which aims to mitigate speculative market fluctuations for sovereign bonds, does not cover supranational issuers.

Secondly, in the absence of specific hedging instruments, such as bond futures for German Bunds, bonds of supranational issuers are priced using the euro-denominated interest rate swap curve as a benchmark. Against a backdrop of rising interest rates over the past two years and heavy use of interest rate swaps by financial investors to hedge their bond positions, the spread of interest rate swaps against German Bunds has sometimes widened sharply, mechanically pushing up yields on the four European supranational issuers.

Thirdly, the non-inclusion of European supranational issuers in global sovereign bond indices has also limited the interest of some index funds in their bonds.

Finally, the four supranational issuers lack security lending facilities similar to those used by sovereigns to manage the liquidity of their bonds.

Future considerations

Over and above these conjunctural and structural factors that are holding back the consolidation of the European safe asset base, Europe needs a strong political commitment to ensure the continued success of the four European safe assets.

In particular, the concerns in the market regarding the EU as a bond issuer are twofold. Firstly, the market is wondering what will happen once the temporary NGEU mandate expires and new loans cease after 2026. Secondly, questions relating to indirect and direct taxation, which would provide the EU with its own financial resources, similar to the competence of sovereigns to collect taxes, remain unresolved.

In the longer term, there are political issues beyond the scope of this article that will need to be addressed. But the prevalence of more safe assets supporting borderless investing across Europe from completion of a capital markets union and further internationalisation of the euro offer investors, businesses and citizens enormous advantages. These changes also place the European capital markets on a more level footing with their counterparts in other major economies such as the United States.

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